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# **NAVAL POSTGRADUATE SCHOOL**

**MONTEREY, CALIFORNIA**

## **THESIS**

**ECONOMIC SECURITY ENVIRONMENT AND  
IMPLEMENTATION OF PLANNING, PROGRAMMING,  
BUDGETING, EXECUTION (PPBE) SYSTEM  
IN GEORGIA**

by

Maia Chiabrishvili

June 2004

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**ECONOMIC SECURITY ENVIRONMENT AND IMPLEMENTATION OF  
PLANNING, PROGRAMMING, BUDGETING, EXECUTION (PPBE) SYSTEM  
IN GEORGIA**

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Submitted in partial fulfillment of the  
requirements for the degree of

**MASTER OF BUSINESS ADMINISTRATION**

from the

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## **ABSTRACT**

This thesis identifies and analyses the main aspects and challenges that have occurred to Georgia's National Security after regaining independence. Economic Security is the initial subject of analysis. The thesis examines the Ministry of Defense as a public sector agency; the problems in government institutions resulting from the old Soviet mentality and the lack of leadership skills in a democratic society which led to Georgia's political crisis and economic decline, as occurs to most countries in transition; specifics about the distribution of financial power in an unstable economic environment decline and the negative effects of instability on defense reform processes, particularly in the implementation of the PPB(E) System.

The intent of this research is to explain the interrelationships of harmonious, sustainable growth and PPB(E) as an established system for transparency. The thesis provides a record and explanation of events that caused the current problems in defense planning and the budgeting process as well as recommendations for future improvements to the PPB(E) System in the Georgian Armed Forces (GAF). The main focus is on policy formulation and budget execution; performance; accountability; fiscal discipline; and transparency. The conclusion summarizes the paper, which presented the arguments for successful reforming processes in the GAF, particularly in its medium-term budgeting cycle.



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## **I. INTRODUCTION**

### **A. PURPOSE**

This thesis analyzes political and economic preconditions, possible problems, and the positive future outcomes the Georgian Armed Forces might experience if implementation of the Planning, Programming, Budgeting and Execution PPB(E) System is accomplished successfully.

### **B. BACKGROUND**

The political changes that took place in Georgia after the collapse of the Soviet Union caused the need for painful economic reform processes. Political democratization was expected to lead to the economic liberalization, and consequently to growth. Generally, market reforms can lead to the success in authoritarian as well as democratic environment. They also may fail. In Georgia, unsuccessful reforms resulted in regime changes. Even if political failures did not arise, transition, it appears, involves large initial costs. [Ref. 1] During the period of independence, political decisions on economic liberalization and privatization allowed international investment to flow into the country. However, these reforms were fragmented and no unified political and economic program existed for development. They did not aim for sustainable economic growth, and therefore, they remain incomplete.

Georgia is under a gradual transition and is more likely to maintain political and economic stability. However, the macro economy is not stable enough for sustainable recovery. The achievement of positive correlation between democratization and economic liberalization has not yet occurred.

Erosion of political support for democratic institutions has resulted from poor economic performance. Likely symptoms of the failure stem from current Georgian reality: increase in political cynicism and apathy, decline in effective political participation and inability to generate representative ruling coalitions. These symptoms led to economic crime, civil violence and organized revolutionary activity which has resulted in the election of a new government. Dysfunctional political and economic institutions were mirrored in mismanagement of public spending. The entire political and

economic environment, lack of experience and skilled professionals, plus mismanagement in public spending resulted in a permanent biased attitude to appropriate defense spending.

Relative to the creation of the Georgian Armed Forces (GAF), the financial system began with the old Soviet principles and rules, whereby budget development and expenses were linked to virtually unlimited centralized financing. As market economy principles were introduced into the country, the MOD system needed to be modernised. In November 1998, the MOD decided to introduce a proven planning, programming and budgeting system, based on the Defence Resource Management model, as a long-term programme development means. This model of resource management is a long-term, unit-oriented force and expenses model in which all the resources connected with the defence sphere and force structure are reflected.

It is necessary to distinguish two meanings of Defense Budgeting. One concerns Defense Budgeting in its narrow sense, meaning the completion of Budget Estimation forms and submitting them to the Ministry of Finance. Another meaning takes into account the entire decision-making process that defines national interests and threats, develops strategy to deal with them, produces the Armed Target Force structure, and programs with alternative options and Budget Estimations - called Planning, Programming and Budget System (PPBS). The principles and main idea of Defense Planning are approximately the same in all Western countries, despite differences in specific features. Currently Georgia is about halfway from defense budgeting in its narrow sense to its broader understanding.

### **C. SCOPE AND METHODOLOGY**

The scope of this thesis will include: (1) an analysis of level of correlation between democratization and economic stabilization in Georgia, (2) a description of the current stage of PPB(E) system development, (3) an in-depth examination of the prospects for complete and successful implementation of a simplified form of the PPB(E) System in Georgian Armed Forces.

The methodology used consists of the following steps.

- A literature search of books, journal articles, and other publications about the analysis of democratization processes, sustainable growth and the PPBS system.
- Identification of significant problems anticipated in full implementation of PPBS in Georgia.
- Identification of alternate ways to change the Georgian MOD and other governmental organizations and processes to meet PPBS requirements.
- Presentation of recommendations associated with complete shifting of defense budgeting in Georgia toward PPBS and its possible positive outcomes not only for the MOD but also for the Georgia's economy.

#### **D. ORGANIZATION OF STUDY**

The thesis is organized as follows. The first chapter briefly explains the reasons for this thesis. The chapter explains why the Georgian Government and Georgian Ministry of Defense should fully implement the adapted PPB(E) system as well as how the problem will be examined.

Chapter II analyses the Georgian national security environment. Section A traces the general data about Georgia; and the determinants of National Security. Section B describes the preconditions of sustainable growth taking account of the specifics of Georgian reality and international aid and the correlation between politics and economics in a new Georgian democracy. Section C of Chapter II analyzes problems inhibiting sustainable growth. It specifies and describes dysfunctions of the State institutions, namely the impact of corruption on democratization and shortfalls in State budgeting practices. Interrelationships between the political, economic and military security of Georgia are the focus of this section.

Chapter III describes the current condition of defense planning in GAF. This chapter identifies the objectives of defense planning reforms and the key components of the new system. Attention is devoted to the defense organization as a Public Sector Agency. Then, methodological foundations of the reform process and its guidance objectives, priorities and timing of planning cycle are described. The last part of the chapter analyses the means for obtaining the system and describes the implementation problems encountered.

Chapter IV is devoted to future plans. Institutional (external) and inside-the-Ministry changes are analyzed and expected advantages of implementing the adapted (draft) PPB(E)S in GAF are presented in addition to considering the military advantages from implementing the PPB(E) system. An attempt is also made to describe the economic rationales for changing the system from annual planning experience to mid-term planning practicing. Chapter V presents conclusions and recommendations.

## II. THE ECONOMIC ENVIRONMENT IN GEORGIA

### A. INTRODUCTION

#### 1. General Data about Georgia



Figure 1. Map of Georgia (From: Ref. 3)

Georgia is a country in the Southern Caucasus with population of 4,934,413 (July 2003 est.) covering about 70,000 square kilometers. It is bordered by Russia, Azerbaijan, Armenia, Turkey and the Black Sea.

The country has traditionally served as an important trade and transit corridor between Europe and Asia. This very favorable politics resulted in political, economic and cultural renaissance in the 12<sup>th</sup> and 13<sup>th</sup> centuries.

Georgia has held numerous lengthy wars with the powerful empires such as Persia, Byzantium, Turkey. By the 16<sup>th</sup> century, the State was seriously weakened and threatened by Muslim empires and concluded the Georgievsk treaty with Russia as a neighboring Christian State in 1783. Russia violated almost all aspects of the treaty and Georgia has been a completely dependent Caucasian region of Russia since 1801.

Georgia regained its independence in 1918 after Russia's Socialist revolution. Communists occupied the country in 1921. The 70 long years under the Soviet Union separated Georgia from the rest of the world through the "iron curtain," keeping it far from the civilized theories and practices about the political fundamentals of building the state, market economy principles, and the advantages of globalization.

Georgia was among the first republics of the former Soviet Union to declare independence in April 9, 1991. Although Soviet statistics indicated that Georgia's per capita income was relatively low among the republics, it was in fact better-off due in part to a strong tradition of entrepreneurship and an agriculture sector with significant private sector activity.

Georgia is resource-rich country. There are approximately 300 known mineral ores in the country. The principal mineral resource is manganese. Total coal reserves are 400 million tons and known oil reserves are 27.5 million tons. About 40 percent of the land is agricultural, and 40 percent forested.

The existence of the Soviet Union was based upon an extensive, non-rational use of natural resources. Industrial development was dependent on hard labor and a cheap workforce. Under these circumstances, the state political and economic systems were facing potential failure. Significant complex inner economic puzzles were only part of the problem. Outside political pressure, resulting in involvement in the Cold War during the long period of Soviet rule served as the cause for the breakdown of the empire. The accelerated determination of some former Soviet republics for the reestablishment of national independence was an additional factor which accelerated this process. [Ref. 2]

The new government of Georgia could not foresee the possible consequences after declaring independence in 1991. Conflicts and economic collapse occurred. Social conditions of the majority of population have worsened dramatically. The population below the poverty line is 54% (2001 est.); the unemployment rate is 17% (2001 est.) and the inflation rate (consumer prices) is 5.2% (2002 est.) [Ref. 3].

In 1991, the first IMF mission arrived in Georgia, became familiar with local political and economic circumstances and has permanently provided the government with recommendations on macroeconomic stability. Little or no interest and attention paid by state officials to the recommendations resulted in negative tendencies and movement from positive peace to negative peace with social unrest, political disorder and instability and economic malaise. Later, the situation worsened and the country fell into conflict and then crisis. Georgia was involved in ethnic conflicts first in South Ossetia and then in Abkhazia. A political, economic and military strength war was doomed to fail.

Only after the long recovery, in 1996-1997, were the highest rate of economic growth and a very moderate rate of inflation observed. Macroeconomic stability makes business environment more acceptable to investors. However, per capita GDP is still as low as US\$700, i.e. US\$ 2 – per day. This indicator represents only 40 percent of the GDP before gaining independence. The indicator of state expenditures (government spending as a percent of GDP) is also one of the lowest in the Commonwealth of Independent States (CIS), or 18.5 percent of the GDP (2001 est.).

Unresolved conflicts in Abkhazia and South Ossetia had a major negative impact that considerably diminished the economic potential of the country. Losing control over the Abkhazia territory has played a paramount role in weakening the economic potential of Georgia.

The Trans-Caucasian highway, the strategically important route connecting Georgia with Russia, passes through another region in conflict, that of South Ossetia. This is the shortest way between the European part of Russia and the South Caucasus, Turkey and Iran. Various barriers, such as official or criminal customs regimes, restrictions, corruption, illegal trade, etc., prohibit the complete utilization of its potential.

A peaceful revolution in November, 2003 brought a new reality to Georgia in a newly elected President, Parliament, and newly assigned government. Legislative and executive bodies of the country face the task of finding a quick solution to the accumulated complex problems, such as uncontrolled economic borders causing increasing smuggling, an unprotected domestic market, the criminalization of businesses;



a large shadow economy, widespread corruption; financial and budgetary crises based on insufficient tax collection and a permanent negative trade balance; low level of investments, capital outflow; growing foreign debt burden; decreasing production output; the burden of financial provisions for refugees; intense outflow (migration) of intellectual potential; and a high crime rate. [Ref. 4]

## **2. Determinants of National Security**

The economic environment in the state is closely related to the political environment. These two aspects of national power together with military security represent the basis for stable and sustainable growth.

Georgia is a country in transition, attempting the ways of democracy. The initial effects of transformation in all eastern European and post Soviet states have involved substantial falls in output that do not correlate with initial macroeconomic instability. At the same time, macroeconomic stabilization and control are important for sustainable recovery. Recovery itself is associated with indicators of progress in micro and macroeconomic reforms.

Varying challenges of reform in transitional countries depend on differences in the initial political situation, in economic starting points and in the shocks experienced along the way. Some things, such as macroeconomic restraint, price liberalization, and trade liberalization, can be accomplished in the short term. Privatization, effective corporate governance, and financial-sector reform take much more time. The first stage of reforms is intended to start the process of transition to a market-oriented economy. The next stage is the initial building of market economy foundations through institutional and legal reforms. The process of growth and development or “catch-up” resulting from joint political and economic efforts is always considered successful in the future.

It is not difficult to recognize serious macroeconomic disequilibrium such as high levels of inflation, or budget deficit out of control or a seriously distorted economy at the starting stage of transformation. The difficulty is how to achieve both restraint and liberalization, and to deal with the side effects of dislocation, interest group pressures,

and political rebound for example. A strong need for well-designed institutions arises, and only electing a competent administration and strong government might be a resolution.

The following connections and relationships attempt to analyze the points of interest of this chapter.

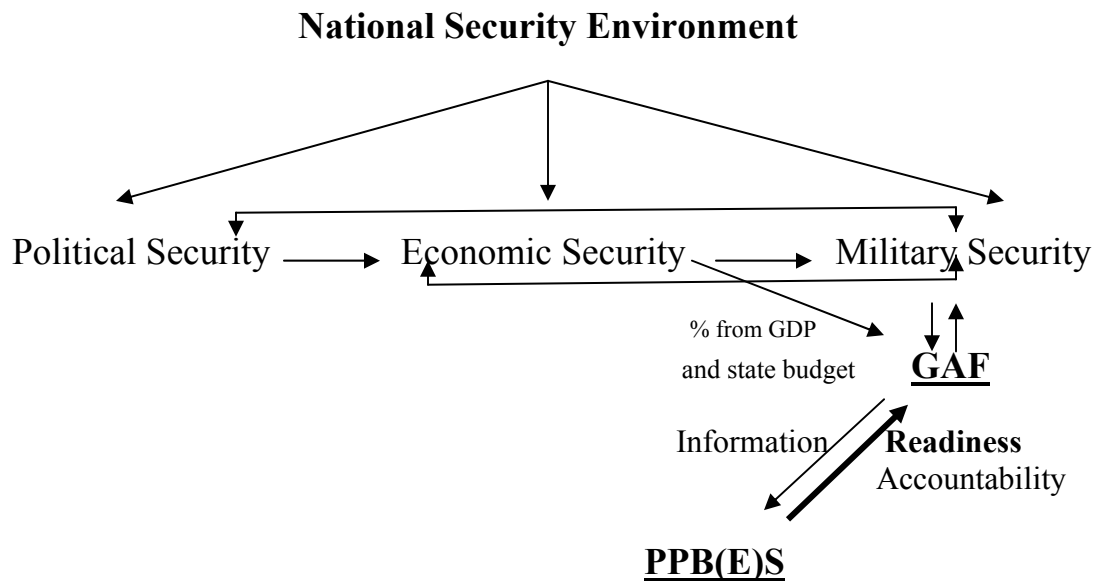


Figure 2. Scheme of the National Security Environment

The following sections of this chapter describe the correlation between politics and economics in Georgia as a country with a new democracy, dysfunctions of the state institutions (Section B); and important preconditions for sustainable growth (Section C).

## B. PRECONDITIONS OF SUSTAINABLE GROWTH

Transition needs to be planned and the institutions that support a market system need to be designed.

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### 1. Specifics of Georgian Reality

After the collapse of the Soviet Union, almost all countries regaining independence have faced an economic fallacy about economic development and the

transition has been a much more complex and costly process than simple phasing out the old planning system while promoting private property and markets. Complexity is due to the urgent need for rapid macroeconomic stabilization. Georgia experienced the general paradox about the transition. Its desired end-point is a market system with a non-heavy government (liberalization); but transition as a process needs strong institutional, economic, and social policies (administered changes). The proper mix of liberalization and marketization based on proper institutionalization usually results in a better outcome. [Ref. 5]

In much of traditional thinking, governments and markets have been conceptualized as opposing forces. The advice given was always that if the state wants the markets to function properly, then the governments need to reduce interference. Stiglitz rejects this proposition. [Ref. 6] He argues that good governance is a prerequisite of effective markets. As G. Soros notes, “Markets are designed to facilitate the free exchange of goods and services... but they are not capable, on their own, of taking care of collective needs such as law and order or the maintenance of the market mechanism itself”. [Ref. 7] Economists are often torn between two conflicting perspectives. On the one hand, good economic policy should produce favorable outcomes, and therefore, prove also to be good politics. On the other hand, the implementation of good economic policy is often viewed as requiring “strong” and “autonomous” leadership. [Ref. 8]

Georgia failed to administer the step-by-step measures of transitional development. This was caused partly because mistaken policies resulted in loss of historical territories; partly because incorrect institutional and fiscal policies resulted in corruption and budgetary system shortfalls; and partly because misuse and mismanagement of international aid and the unwillingness of politicians to become astute providers of that aid resulted in extreme poverty for the society. Political measures proved insufficient to compensate for a lack of understanding of economic growth. Generally, “the trouble with economics is precisely that its obsession with growth leaves issues such as sustainability out of account”. [Ref. 9] The greatest weakness of Georgia’s

government is that it never stated the problem of how long it would take to catch up with the West. Therefore, no clear, reasonable economic policy explaining the character and combination of forces that drive long-term growth was established.

Typical neo-classical understanding of the production model and framework takes into account just two factors of production: capital and labor. The simple model describes a relationship where output depends on the amount of two inputs employed, capital and labor, and on the efficiency with which they are used ( $Y=f(K;L)$ ). Some sources add knowledge to this model. [Ref. 10] The new production function is more believable and is supported by the experiences of former underdeveloped countries that achieved significant economic progress. Georgia has failed to exploit the advantages of having capital because of the mismanagement of privatization. Microeconomic distortions were very costly. Privatization resulted in the malfunctioning of the old enterprises which, in turn, caused long-term unemployment. Macroeconomic difficulties were alleviated only with increasing imports. Among the imports were significant amounts of agriculture products, which the Georgian agriculture sector could produce with effective economic policies. The import-substitution policy was not used at all. There was also no concentration of government policy on knowledge, which has resulted in the significant outflow of intellectual assets.

David M. Gould and Roy J. Ruffin summarize the factors that have been shown to influence growth rates. Analysis indicates that factors associated with increasing human or physical investment tend to enhance technological progress and economic growth. On the other hand, factors that reduce incentives to invest, or interfere with well-functioning markets, tend to reduce growth (see Table 1).

Table 1. Determinants of Economic Growth (From: Ref. 11)

<b>Growth Enhancing</b>	<b>Growth reducing</b>
Schooling, education investment	Government consumption spending
Capital savings, investment	Political, social instability
Equipment investment	Trade barriers
Level of human capita	Socialism

World Bank materials on Georgia's public expenditures and research done at the Parliament Budget Office prove that little investment in schooling, education; misplaced investments in equipment, low level of capital savings, decreased level of human capital along with prolonged political and social instability do not allow the Georgian economy to grow in a sustainable manner.

Formulating the budget for the FY 2004 makes it easier to understand the strengths and weaknesses of the process.

The following macroeconomic indicators comprise the 2004 State budget:

- The rate of economic growth is planned around 4.5 percent, achieving 8,852 million Georgian Lari (\$1=2.19 GEL) nominal GDP. This rate is lower than in 2002 (5.3 percent), but it is higher than the average growth rate in 1998-2002 (3.7 percent).
- The GDP Deflator for FY2004 will continue at the FY2002 level (104.4 percent).
- The rate of GDP growth should be maintained by keeping moderate rates of inflation (around 5 percent). In this case, the consumer price index trend will remain at the level formed in 2000-2002.
- Continuing the strict monetary policy of the National (Central) Bank will make it possible to keep the exchange rate of national currency stable. It will not exceed 2.39 USD for FY2006. The path to this goal is a moderate increase of M3 by a maximum of 15 percent. For FY2002, this indicator has increased by 17.9 percent (in comparison with the previous year); in 2001 – by 18.4 percent; in 2000 – by 13.9 percent. Thus, in successive years, this indicator will be maintained at the previous years' level.
- The National Bank does not plan to lend money to the State for funding the budget deficit. Long-term credits for funding the budget deficit will not exceed 30 million GEL. Due to these and other economic factors, the expectation is a reduced budget deficit by up to 1.47 percent of State budget by FY2004 (in 2000-2002 – 2.8-3.1 percent).
- During this period, a meaningful factor of economic revival is the construction of the Baku-Jeihan project.

Table 2. Main Macroeconomic Indicators of the State Budget (From: Ref. 21)

<b>Years</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003 (plan)</b>	<b>2004 (prognosis)</b>
Nominal GDP (mil GEL)	6016	6632	7298	8090	8852.7
Growth Rate of Nominal GDP (comp. previous year)	106.2	110.2	110.0	110.9	109.4
Deflator	104.2	105.8	104.4	104.4	
Nominal GDP, per capita	1307.8	1441.7	1586.5	1758.7	1924.5
Growth Rate, Real GDP	2	4.7	5.3	4.5	4.5
Nominal GNP (USD)	3053.8	3203.9	3332.4	3595.6	3934.5
Nominal GNP, per capita (USD)	663.9	696.5	724.4	781.6	855.3
Consumer Price Index	3	5.7	5.5	5	5
Deflator	4.1	5.4	6.3	4.2	4.7
Exchange Rate	1.97	2.07	2.19	2.19	2.25
State Budget Revenues and Grants (mln GEL)	640.3	740.0	816.8	1103.9	1171.3
Expenses (mln GEL)	833.9	906.0	1040.7	1343.7	1301.8
Deficit	318.6	193.6	223.9	239.6	110.5

*Population: 4.6 million*

No significant positive changes in foreign trade are expected for the year 2004. The current and future trade balance will become even worse. The indicator of negative trade balance will increase up to \$497 million. In 1997-2000, the negative balance was decreasing and export potential of the state was increasing because of several changes throughout the economy, especially in the raw materials' sector. After 2000, this indicator worsened, and a more or less stable exchange rate of national currency and low inflation rate were maintained. It seems that these processes will continue in the future and no measures of monetary or fiscal policy will be applied. Although the share of exports in foreign trade will remain unchanged even though the negative trade balance will increase in 2004 by \$120 million in comparison with 2002. As a result, some stabilization of the present situation is planned in foreign economic relations.

The planning of main macroeconomic parameters is based on two important factors: realization of moderate monetary and fiscal policies promoting a low rate of inflation and the stability of National currency; and construction of Baku-Ceihan pipeline

with significant foreign investments. The policies and economics of this pipeline will become a factor for more sustainable growth. As a result, aggregate demand and supply will increase, resulting in increased share of imports and increased smuggling is not excluded. However, if changes in fiscal policy and institutional reforms do not support these processes, Georgia will experience only temporary revival of the economy rather than long-term sustainable growth.

Under the improved conditions, 2004 budget revenues are expected to reach GEL 1087.6 million (12 percent of GDP; 2 percent more than the 2002 level). Positive trends of macroeconomic development will have a positive effect on budget revenues.

The dynamics of the state budget of Georgia do not indicate any clear priorities or directions for economic development. Inappropriate funds (so-called omnibus) consist of more than 25 percent, while funding for social needs (health care, education, social insurance and provisions, housing and communal services) totals only 34 percent because of problems with the collection of custom taxes, shortfalls in fiscal policy, and failures in budget execution.

Table 3. State Budget Expenditures, Dynamics, FY 1997-2004 (From: Ref. 21)

Functional Codes of Expenses		1997	1998	1999	2000	2001	2002*	2003*	2004* (Project)	Rate of Growth 2004 to 2002, %	Rate of Growth 2004 to 2003, %
01 00	Common Purpose Government services	95.8	65.6	123.5	101.6	174.4	150.1	182.8	172.2	114.7	94.0
02 00	Defense	67.5	56.5	35.5	28.8	37.1	49.9	74.5	74.3	148.0	100.0
03 00	Public Order and Security	93.3	65.9	75.7	63.8	80.4	105.1	124.7	113.6	108.1	91.0
04 00	Education	46.3	30.4	29.3	26.8	31.7	47.0	84.6	88.7	188.7	105.0
05 00	Health Care	25.6	26.7	15.7	20.4	33.5	74.0	84.6	97.8	132.2	104.0
06 00	Social Insurance and Provisions	190.0	216.1	246.9	240.4	254.3	248.6	296.9	315.0	126.7	106.0
07 00	Housing, Communal Services	5.8	7.0	5.1	4.2	3.8	4.4	4.8	4.5	102.3	94.0
08 00	Culture, Sport, Religion	36.1	33.1	25.1	21.1	19.9	26.4	29.3	28.0	106.1	96.0
09 00	Energy and Fuel	11.8	3.7	12.5	25.3	8.6	44.0	83.7	64.7	147.0	77.0
10 00	Agriculture, Forestry, fishing, Hunting	17.4	22.2	15.5	12.3	15.1	25.5	49.1	59.7	234.1	122.0

Functional Codes of Expenses		1997	1998	1999	2000	2001	2002*	2003*	2004* (Project)	Rate of Growth 2004 to 2002,%	Rate of Growth 2004 to 2003,%
11 00	Mining industry and mineral resources other than fuel, manufacturing industry, construction	2.7	2.0	0.7	0.3	0.5	1.0	1.6	1.6	160.0	100.0
12 00	Transportation and Communication	38.6	49.3	35.7	31.0	34.2	80.3	88.1	80.7	100.5	92.0
13 00	Environment, Natural Resources Protection	3.4	15.0	2.7	1.7	2.3	6.9	12.2	8.6	124.6	70.0
14 00	Expenses, not classified by main groups of classification	142.5	203.4	280.6	255.7	240.0	264.0	352.4	382.5	144.9	109.0
	<b>Total</b>	<b>776.8</b>	<b>796.9</b>	<b>904.5</b>	<b>833.4</b>	<b>935.8</b>	<b>1,127.2</b>	<b>1,469.3</b>	<b>1,491.9</b>	<b>132.4</b>	<b>101.5</b>

(Million, GEL)

\*Amounts include the funds gained by own activities (so-called special funds) together with appropriated funds. It is interesting to note, that these categories often remain unfunded

In the last five years, Georgia has been further buffeted by the Russian crisis. Although some progress has been made in structural reform including trade liberalization, legal and regulatory reform, privatization and competition, banking sector restructuring, and judicial and health sector reforms. However, these successes have been diluted by weak fiscal management and poor public sector capacity, which have affected the implementation of second-generation reforms. Budget management is a priority problem, since resource allocation is not well linked to sector objectives, programs or policies.

Due to weak governance that resulted in an economic collapse by 2002, real GDP was only 30 - 35 percent of its 1990 level. In 2002, a slowdown in global economic activity occurred. In addition, a currency crisis in Turkey significantly reduced demand for Georgian exports. This had a strong negative impact on industry, since exports consist mainly of industrial products including raw materials and semi - processed goods.

Pervasive corruption and the arbitrary implementation of laws and regulations limit Georgia's economic prospects. A recent World Bank study indicated that Georgia has one of the largest informal economic sectors among former Soviet states. Economic activity which is illegal or off-the-books , -the so-called grey economy, constitutes up to 80 percent of overall output. By 2002, the national economy contracted to 38 percent of



its adjusted GDP purchasing power in 1989. Georgia's economy suffers from a huge external debt of \$1.7 billion with payments to Paris Club creditors scheduled to start in 2004 and extend over 15 years. Foreign debt is more than half the country's GDP. Presently 51.1 percent of the population lives below the poverty line and 23.6 percent is unemployed. Widespread illegal activities undermine the competitiveness of legal imports and locally produced goods. Privatization failures, limited investment and inadequate restructuring have also constrained manufacturing growth resulting in urban unemployment greater than 40 percent.

Most Georgians earn their livelihood in the agricultural sector. However, agricultural output is limited by many types of dysfunctions. Although Russia was traditionally a major export market for Georgian goods, Russia's 1998 economic downturn caused market restructuring in Russia, and Georgian exports appear to be excluded. A severe drought further devastated Georgia's agricultural sector in 2000.

As a result of investments in the Baku-Supsa "early oil" pipeline, Foreign Direct Investment (FDI) peaked at \$288 million in 1998. The expectation is that the FDI associated with the Baku-Tbilisi-Ceyhan oil pipeline will revitalize the economy to robust growth rates, estimated at 6.5 percent in 2003 and 9 percent in 2004. The Baku-Tbilisi-Erzurum gas pipeline could lift Georgia's economic growth rate even further to 12 percent in 2005. [Ref. 12]

Georgia's economy is far below its production possibility frontier (ppf). In other words, the economy does not achieve the maximum possible output given its resources.

## **2. International Aid**

...external resources reduce the costs both of reform and of doing nothing  
– that is avoiding reform.

Rodrik, Dani [Ref. 8]

Based on academic papers aiming to analyze the foreign aid, some pessimistic observations emerge. The prospect of aid can actually delay stabilization, by inducing groups to postpone making sacrifices until aid actually materializes. [Ref. 13] The effect on reform is consequently unclear. Jeffrey Sachs supports a form of foreign aid. He

argues that a government committed to reform is needed before aid can be beneficial. However, once such a government is in place, the international community should be forthcoming. What aid can accomplish, even if it is small in relation to the country's problems "is help good governments to survive long enough to solve problems." The problem is that aid can also help bad governments survive. [Ref. 14] Sachs would respond that aid must come with a heavy dose of conditionality. This is well recognised, and both the IMF and the World Bank allow access to their resources conditional on "good behavior on the part of the borrowing governments."

Georgia joined the World Bank in 1992 immediately after regaining its independence. The Bank's overall program focuses on four key objectives in support of reducing poverty. The Bank Group assists the Government in attaining faster and more broad-based growth through the removal of policy, institutional and infrastructure obstacles to private sector development; developing and strengthening human capital; and providing some minimum social protection; strengthening public expenditure management through annual expenditure reviews; improving governance and institutional capacity. On the macro-level, this involves fiscal consolidation, transparency and coordination as well as the restructuring of administration. On the micro-level, the focus is on local government empowerment, as well as administrative streamlining, accountability and disclosure, and the training of staff and managers.

It is important to focus public expenditure management in order to identify the challenges that the Georgian Armed Forces faced in its attempts in the PPB system implementation process.

The proper management of public expenditure requires solving several problems made by governments of transitional countries: [Ref. 15]

- There must be strong links between policy formulation and budget execution, meaning several things in practical terms:
  - Making the senior people create reasonable and financially feasible statements of their goals and priorities (i.e., their policies), and this must be the starting point;
  - Multi-year plan to accomplish the stated goals;
  - Budgets built based on the plans that implement the goals;

- Strong monitoring of budget execution to ensure the original goals are being accomplished.
- Focus on performance must be a key theme in making reforms work.
  - Resource management must focus on what the State wants to accomplish (organization outputs) not on just how much money made (inputs).
  - The leadership must talk and act in terms of outcomes (i.e., performance) to see the real changes.
- Accountability is another key point in workable reforms.
  - The only way to make reforms efficient is to hold executives accountable for how they use resources (and not how many). However, executives would be hold accountable only if they have a voice in the formulation of plans and budgets. Without their personal responsibility, the state cannot obtain accountable subordination;
- Fiscal discipline means living within government specified fiscal limits. It is dangerous to manage in a continuous ad hoc basis, especially when this concerns resource decisions;
- Transparency is the most critical aspect. It is the most effective antidote to corruption and other unfair benefits.

The new government of Georgia fully recognizes the weaknesses of the former regime in accomplishing the aforementioned requirements of precise management of public expenditures, attempts to analyze past mistakes and expresses the willingness to undertake the missed opportunities.

The World Bank should make anti-corruption a core activity of its country assistance strategy. According to the organization's assessment, the country faces five future strategic challenges:

- Improving governance and reducing corruption. Despite far-reaching economic and financial liberalization, little sustained improvement in economic or social indicators is possible until governance improves. Moreover, better governance, including fewer bribes-seeking and less tolerance of crime is essential for the country to reach its full economic potential. There is hope that the new president's administration will improve government capacity. The president's initial action to reduce the oversized apparatus is a first step towards building a more flexible bureaucracy.

- Enhancing fiscal management to maintain macroeconomic stability. Fiscal performance has significantly worsened last year, with tax revenues falling short of the targets agreed with the IMF, and the accumulation of substantial new budget arrears. It is essential that Georgia improve its performance in revenue collection given the need to cover the cost of basic social services and economic rehabilitation while meeting debt servicing obligations. In addition, improved public expenditure management is essential to ensure that scarce public funds are spent on areas of high priority. While the Ministry of Finance has begun a program to improve budgetary processes, a more systematic approach is needed.
- Enhancing the business environment. It is critical to remove constraints to private sector development and improve the institutional framework, including reform of legal, regulatory, and tax administration systems. It is also necessary to improve the policy-making capacity of government officials, complete restructuring of the economy and improve access to finance. At the same time, it is very important for international players to rethink their Georgian assistance strategy. The most vital sectors of the Georgian economy have received little or no support from international lending organizations.

International assistance over the near term should be focused on the realization of the country's entrepreneurial potential. Such a direction could prove helpful to the Georgian government, easing the financial burden of promoting economic growth. Accordingly, in the coming months, the new administration should take action to simplify the start-up process for small businesses, while making tax legislation more conducive to promoting new ventures.

- Building human capital. Since 1989, the Georgian population has decreased by 900,000, with many emigrants seeking jobs abroad. Currently, they are dispersed throughout the world working physically or making successful scientific and other careers. Attracting them back with reasonable incentives will allow the development of much human capital, which is a key to achieving sustained poverty reduction.

While the World Bank envisages a wide range of measures to improve the effectiveness of education and health programs, the Government will need to prioritize and sequence the measures in more detail, and allocate adequate budget resources.

- Reducing the vulnerability of the poor. Improved social protection is essential to reduce poverty. In order to avoid a further accumulation of pension and social assistance payment arrears, and ensure the long-term sustainability of the social protection system, Georgia will need to develop a well-targeted, affordable, and fiscally sustainable system simple to

administer and monitor. Priority should be given to assisting the most vulnerable such as single pensioners, children in institutions, and the disabled. In addition, child welfare policies need to be improved, and community-based social services developed [Ref. 16].

A stable economy would greatly increase the new administration's stated desire of integrating Georgia into Western economic and security structures. This also will allow for the full implementation of the PPB(E) system in the reformed structures of the Georgian Armed Forces, manage the programs and resources, and serve transparency and accountability.

### **C. CORRELATION BETWEEN POLITICS AND ECONOMICS IN GEORGIA - A COUNTRY WITH A NEWER DEMOCRACY**

After existing 70 years under a totalitarian environment and finally regaining independence, Georgia has had to decide the best path for the transition from the authoritarian/totalitarian regime to democratic governance. Why democracy? Larry Diamond's perspective is that "democratization is generally a good thing and democracy is the best form of government" [Ref. 17]. One argument for this statement is that democracy promotes economic growth, creates wealth and establishes the rule of law. There is clearly positive correlation between democratization and economic liberalization. The higher the democracy score, the more liberal the country's economy.

Any transition is cost oriented. Przeworski argues that whatever the consequences, reforms produce economic devaluation in the short run. The success of transition largely depends on the strategy used: gradual, radical, or rapid. Rapid transformation promises faster recovery but with much higher costs. The strategy of gradual changes may be less costly in the short run, but "If the adjustment is too gradual, opposition will gather and the process will be derailed" [Ref. 1: p. 165]. Current problems with political and economic instability in Georgia mostly occurred from the gradual transitional processes, and mismanagement of funds devoted to rapid transformations, have appeared to be wasted. More precisely, this is the combination of political and economic conditions when market reforms returned controversial outcomes.

## **1. Dysfunctions of the State Institutions**

This sub-section considers the institutional factors inhibiting economic growth in Georgia. These factors are the prevalence of informal institutional forms; a high level of corruption; weak tax administration; and inefficient privatization.

### ***a. Impact of Corruption on Democratization in Georgia***

Corruption and the shadow economy are the most probable outcome of the state institutions' dysfunctions and the most challenging "actors" of the democracy. On the one hand, democratic changes and market reforms correlate highly. However, on the other hand, democracy and markets may be asymmetrical in many ways and need a framework of strong institutions to protect small participants.

For many post Soviet societies, "democracy" means increased poverty, social insecurity and ineffective leadership. Corruption still remains a very difficult problem for consolidating countries. Weak political and economic institutions cannot resist or oppose the variety of illegal activities and practices. They often become strongly organized political and bureaucratic networks. These networks slowed down democratic and market processes and undermined their credibility in Georgia. Democracy and economic growth were both weakened. The losers from corruption either became dependent upon corrupt officials or those intimidated by them, and simply found it prudent to avoid them.

Democracy with markets seems most likely to succeed and be less influenced by corruption. Competition strengthens economic prosperity and political accountability. In these conditions, society is less vulnerable to exploitation for political "trade-offs" and it becomes more resistant to corruption. Competition as a core element of the market economy must be orderly and fair. Without market competition and stable democracy, society can become politically insecure. Politicians are unsure of their tenure in office and try to enrich themselves very quickly. Political regimes in Georgia, as in most countries in transition, have held power over a limited territory and population. Markets are global and increasable. This asymmetric relationship creates the breeding

ground for corruption. The connections between the political and economic parts of the state did not legitimately exist and were created under the wrong, uninstitutionalized, corrupt ways.

Huntington has argued, that where political opportunities are scarce, corruption occurs as people use wealth to buy power. Where economic opportunities are few, power will be used to pursue wealth [Ref. 18].

The ties between various sectors of the state and government normally occur at the same levels of power and/or official status. These ties represent horizontal structures of corruption which have been carried over from the old communist system. In Georgia, family and friendship relationships strengthened these networks. The political changes since 1989 have not seriously damaged the networks because most officials at the lower and middle levels of the state stayed in place, and new officials integrated into the system.

Vertical structures of corruption have developed within the same branches of the state and include various administrative levels. They can be characterized as patron-client relationships. The superior provides security, jobs, etc. for a subordinate in exchange for support, loyalty, work, etc. In this relationship, payoffs and personal benefits are expected. Political power as a means of control is paralleled by economic power. Higher officials are not directly involved in corrupt activities but they are well aware of the corrupt activities of their subordinates. This information allows them to put additional pressure on the lower officials. Accordingly, there is sufficient pressure for public officials to play by the rules of corruption.

At present, the level of corruption is so high that many entrepreneurs prefer to operate in the informal sector, or gray market. Such businesses do not pay taxes, and thereby, deprive the government of revenue. It is often cheaper for businesses to function in the shadow economy than to operate in the open, largely because of the punitive tax framework.

A paradoxical situation exists in the Georgian political and economic arena. On the one hand, the Georgian state has no financial means to play a positive role in the economic and social development of the country. Corruption destroys the state budget. On the other hand, based on its monopoly of public services, the bureaucratic apparatus remains a powerful actor.

The horizontal and vertical structures of corruption subvert the division of power, and inhibit the creation of a transparent system of checks and balances. State officials do not control each other because many are corrupt. In turn, public officials are not afraid of punishment if they neglect their duties. Corrupt state officials seriously threaten the efficiency of democratic institutions. The informal financial and other institutions, such as commercial banks, which officials maintain to protect their illegal sources of income, contradict the rule of law, the division of power and the human rights of Georgia's citizens. Corruption has led to the dysfunctions of most of the state institutions, thus eliminating the state's capacity to play a positive role in the development of Georgian society and economy.

Very tight links exist between the consequences of corruption. Political, economical and social consequences overlap and may be summarized as follows. [Ref. 4]

#### **Political Results**

- National development aims including broad political and economic goals are crafted to provide power to a few oligarchies;
- Public trust in the government is permanently decreasing and any progressive government initiative is opposed aggressively;
- Political competition is weakened. The public experiences a growing sense of disappointment and the government institutions formed under democratic values are distorted.

#### **Economic Results**

- The shadow economy grows. Managing development is impossible, and the stability of the national economy is threatened;
- The person who gains an advantage by means of bribery is the winner - not the person who is more competitive. This discredits the concept of the market economy and reduces the effectiveness of the market;
- The privatization process is extensively subverted;



- Budget execution is undermined, resulting in growing budget deficits. Permanently decreasing budget revenues are used inefficiently. Prices increase due to expenses incurred by corruption. This instability and uncertainties results in no opportunities or incentives for efficiency;
- The market experiences rapid slow-down of production while its agents have almost no hope that the government will ever enforce fair market rules;
- The effectiveness of the national economy falls while corruption becomes increasingly important in the private sector.

### **Social Results**

- Significant sums are withdrawn from public development. Due to the lost territories, smuggling and other consequences of political dysfunctions there are serious shortfalls in tax and customs revenues and the ability of the government to solve social problems is minimal;
- As a result of increasing imbalance in the distribution of wealth in favor of narrow oligarchies, the majority of the population suffers from poverty;
- Law is discredited as a primary instrument for the regular existence of the state and society. Members of society feel themselves insecure and vulnerable to crime and to the government;
- Corruption in law-enforcement authorities facilitates organized crime, which is tightly integrated to corrupt officials and entrepreneurial groups. Their influence increases as the paths to political power and to money-laundering are open and accessible.
- Social tension grows rapidly which poses a serious threat to the national economy and challenges political stability. This mounting tension brought the country to violence and revolution in November 2003, which ended with the fall of President Shevardnadze's regime.

According to the estimates of the international organization "Transparency International", corruption is strong in countries with low-competition economies, while in countries with highly developed competition, corruption is relatively rare.

The intention of the very first steps of the new government is to purge the corruption from the political and economic institutions, and strengthen competition in the economy.

#### ***b. Tax Administration***

The weakness of Georgian state institutions is the unwillingness to pay taxes. That, in turn, further weakens the state. These problems, namely the low rate of tax

collection and the absence of strict financial discipline result in permanent unplanned budget deficits. These are some of components of the economic crisis in Georgia. The share of the state budget in GDP was 12.2 percent in 1998, 11.1 percent in 1999, and 10.3 percent in 2000.

Georgia is one of the first among the post-Soviet countries to have passed a Tax Code (1997). However, the events which followed have shown that even the best laws, mechanically re-drawn from one institutional environment into another, do not necessarily have the desirable effect. Despite the many amendments to the Tax Code, it is still unsuitable. The tax system cannot provide adequate budget revenues.

Reform of the tax service began in 2000. The first results have shown how the country is thoroughly accustomed to illegal institutions and how difficult it will be to transform them. There is an implacable struggle by shadow businesses for the preservation of conditions that are favorable to them.

During last four years, the share of the shadow economy in the total economy was characterized by the following data.

Table 4. Share of Shadow Economy in the Total Economy (From: Ref. 38)

		2000	2001	2002	2003
<b>Total production of the economy</b>	unobserved	32.8	32.9	33.6	31.8
	observed	67.2	67.1	66.4	68.2
	Total	100.0	100.0	100.0	100.0
<b>Total production of the industrial sector</b>	unobserved	55.7	57.3	56.6	51.1
	observed	44.3	42.7	43.7	48.9
	Total	100.0	100.0	100.0	100.0

Despite the reduction of the extent of the shadow economy in total volume production, including the industrial sector, its level is still high and is not decreasing in such spheres of economic activity as trade and service (67.2 percent), hotels and restaurants (70.8 % percent), health care and social service (67.1 percent) , etc.

The political legacy of the former government (uncontrolled territories) permanently aggravates the situation in both the political and economic sphere. The success of the new Georgian government depends on whether it can restore territorial integrity, close and control borders and restore the trust of society towards legal institutions.

*c. Privatization*

The private sector plays a very important role in the Georgian economy. More than 60 percent of employees are engaged in it. Privatization was executed on the basis of the Law “On a Privatization of the State Property”, accepted in May 1997. Various methods of privatization were used: tenders, auctions, long-term transfers of management rights, direct sales and voucher privatization. By 1999, more than 13,000 small and almost 1000 large enterprises were privatized. However, the transfer of state property to private ownership has not resulted in substantial growth of investment, revival of manufacture or growth of labor productivity. Many details of the law were ignored, and mismanagement of privatization led to regulatory, financial and economic violence. Former Soviet enterprises went bankrupt artificially because of erroneous accounting reports, with lowered selling prices making them significantly more affordable to the cronies of former President Shevardnadze.

The bulk of frozen state assets is owned by labor collectives, which are not capable of appropriate management. The other, more profitable assets became the property of former directors. At the same time, the great bulk of the new “successful” businessmen are related to, friendly with, or have a business connection with the supreme officials of the country.

The privatization which has occurred without institutional reforms has not brought the expected results. The financial condition of the majority of the privatized enterprises remains tenuous. The magnitude of investment activity is still insufficient for the maintenance of steady economic growth.

**2. Shortfalls of the State Budgeting**

Dysfunctions of the state institution were strictly evident in the State budgeting system.

**a. *Parliamentary Review and Approval of Budget***

According to the Law of Georgia “On Budget System and Budget Authority”, the President of Georgia submits the document of basic indicators and directions of the annual draft state budget to the Parliament by 1 June of the current budget year. All Parliamentary committees review the document. The Finance-Budget Committee coordinates this process. It requests and obtains needed information from ministries, agencies and other executive bodies and prepares conclusions on the basic indicators and directions of the draft budget. The conclusions are sent to the President of Georgia before 1 July of the current budget year. The President of Georgia presents the draft state budget law to the Parliament three months prior to the start of the budget year.

After preliminary discussions in the committees, the draft state budget law is discussed at the plenary session of the Parliament. The Parliament of Georgia approves the law on state budget before the budget year begins. The Indicative Plan for Socio-Economic Development of Georgia prepared by the Ministry of Economics serves as a formal basis for budget-building. At the starting point of moving to the market economy, it probably is possible to have central planning coincide with market capitalism, the “planned market economy”, e.g., in 1991-1993 in Georgia, there was an attempt to develop the so-called “state capitalism”, but this political and economic movement was not accomplished because of changing governance (Shevardnaze came into the power). Such planning is known as indicative planning because it lacks the command element and generally, it is less influential than in the past.

**b. *Shortfalls of Budgeting and Execution***

Problems related to achieving better budget outcomes encounter different levels from budget preparation up to its execution. This section does not attempt to examine the roots of the budgetary system. The goal is to highlight the main disadvantages of the current mechanism to prevent the analogous mistakes in defense planning on a smaller scale and to obtain real outcomes.

Appropriation of funds in the state budget lacks transparency. Some categories do not clearly reflect the expenditures of the state funds. Existing structures of distributing the budget funds (functional, organizational and economic) are not sufficient

for spending efficiency. Central budget expenditures need to have several ambiguous and unjustified expenditure items eliminated. The level of justification of the submitted proposals is low, and there is no internal controlling mechanism at the Ministry of Finance. The Indicative Plan for Socio-Economic Development of Georgia does not really serve as the basis for the budget, and is nothing more than a formal document. Parliament committees do not have the skills or the responsibility to evaluate proposed budgets adequately.

The draft budget is compiled by Executive branch only. On 1 June of the previous budget year, basic directions of the budget are submitted to the Parliament. Within a month, it is discussed in all committees and the Parliament Budget Office (PBO) [Ref. 20] Conclusions on the presented document are prepared. Normally, the initial version does not become the basis for the Law on the State Budget, which is submitted to the Parliament three months prior to the new fiscal year. The draft almost never reflects the parliamentary conclusions. On the contrary, the final version almost always represents ideas completely different from those in the proposal. Thus, the basic priorities and directions are only written in a formal document. Actually, annual state budgets represent the mechanical, artificial “grouping” of isolated documents, and therefore, do not constitute a coherent economic strategy. A clear, broad picture on economic performance, usable for long-term economic policy is not available. Attempts at strategic budget allocations suffer because a substantial portion of the budget is already fenced and excludes genuine priority setting and budget rationalization.

There is no prior, accurate evaluation of the impact of the budget proposal on revenues and expenditures. As a result, problems with budget execution and budget law enforcement arise quite often. Budget revenues are either significantly reduced or budget expenditures are increased. Thus, in most cases, implementation of the law becomes problematic immediately upon its enactment. Often, the new fiscal year starts with having no approved state budget and it is approved with delays and violations of the legislation. The threats to its legitimate execution lie in its roots. Systematic amendments to the Tax Code deteriorate the parameters of the approved budget.

According to the materials of the Parliament Budget Office, Georgia was to move to program financing gradually starting in 1999. Instead, amounts authorized for some departments and agencies are still present in the State budget with one or two aggregated figures, usually the total amount and the number of personnel. The budget performance, transparency and accountability as the important outputs of the successful budget are not yet achieved.

One can judge the fiscal policy of the Legislative Branch according to the structure of budget outlays. With mid-year revenue shortfalls, the Government changes approved proportions. This is reflected in uneven funding of the departments, agencies and programs. In fact, the budget approved by the Parliament is usually ignored. Sequestration of state budget outlays is routinely not completed on time, and does not account for effects of budget execution on revenue. As a result, budget revenues are spent. These are legalized only after the fact. Usually, this happens during the last days of last month (December) of the fiscal year and state debts grow continually.

The role of line ministries and departments in the budget development and the execution process is being weakened. In most cases, budget ceilings are communicated rather too late to permit a proper review of the activities and prioritization that may have been warranted. The major responsibility for the budget parameters falls only on the Ministry of Finance. According to the Law of Georgia “On Budget System and Budget Authority,” the Government’s report on budget execution is approved in case it is accurate and comprehensive about revenues, expenditures and the legality of spending. The report often reflects the verification of the legality of spending but does not describe how accurately presented numbers are as compared to actual spending. As a result, the legislative branch is not provided with a comprehensive document about budget execution. Yet, no one has been held accountable for violations in budgeting and execution process.

Information on budget execution is very incomplete. Revenues are not sub-divided by activity spheres and goods/services. A real picture of economic performance and setting accurate parameters for future budgets is almost impossible. Information about outlays is very general and published with significant delays of two or three months.

Many of the weaknesses in budgeting generally reflect the failure to address linkages between the various functions. Many factors create a disabling environment for performance in the public sector. [Ref. 21] Thus, it is therefore possible to state the aspects of Georgia's budget system requiring reform:

- Exclusive focus on inputs, when budget performance is judged only in terms of funds spent “in accordance to the appropriations;”
- A focus on only short-term decisions; Inability to take account of long-term real and potential costs;
- Inability to budget in real terms; leading to pressure on aggregate spending or mechanical cuts during the budget execution with negative consequences for the agencies;
- The involvement of the parliament and central economic and fiscal institutions in decision making on the micro level;
- Unexpected, last-minute cuts during budget execution;
- Unpredictability of funding for the existing government policy caused by weak decision-making system and last-minute cuts;
- Strong incentives to spend funds in the first half of the fiscal year, since
  - the current year's spending is the starting point for the future year's budget plans and
  - fear of unexpected cuts during the execution;
- Very little interest in analyzing causes of failures of existing policy; unsophisticated approach to budget analysis from one year to the next;
- Poor linkages between policy and resources; between the center and the line agencies; weak interagency relationships;
- Poor information on performance, and costs of policies, programs and services;
- Lack of incentives to improve the performance of resources provided.

State budgeting and execution system shortfalls and their negative affect on the PPB process in the Armed Forces are detailed further in Chapter III.

### **III. DEFENSE PLANNING AND TRANSFORMATION**

The attempt to analyze defense planning and transformational processes in the Georgian Armed Forces relies on understanding the defense ministry as a public sector agency. This chapter is based on the notes from the GB4014-Strategic Management class and the final case analysis by author of this thesis.

The Methodology of Planning, Programming, Budgeting, Execution System is drawn based on the materials of texts used at NPS. They are “Practical Financial Management: A Handbook of Practical Management Topics for the DoD Financial Manager”, Editor CDR Philip J. Candreva, “Budgeting and Financial Management for National Defense” and “Reform of Program Budgeting in the Department of Defense” by Prof. Jerry L. McCaffery, Lawrence R. Jones, notes from GB 3510-Financial Management in the Armed Forces class and the final paper for this class.

The importance of the accurate system of public expenditures to maintain a strong PPBS in the MoD is discussed. This information derives from the paper “Georgia: Public Expenditure Review” *World Bank Report #22913-ge*, 2002.

#### **A. MILITARY EXPENDITURES AND WEALTH**

National Defense is a classic case of a public good, or collective consumption good provided by the public sector because once provided the additional resource cost of another person consuming the good is zero. The consumption is non-rival and it is very expensive or impossible to prevent anyone from consuming the good. Therefore, the consumption is non-excludable. [Ref. 22]

National defense is almost always provided publicly, even in strongly capitalist market economies. Due to the nature of collective goods, it is difficult for the private market to organize provisions in optimal quantities. Price is not determined in a market.

In a macroeconomic sense, rising defense expenditures could lead to a financial crisis and inflation, as well as an increase in public debt and the money supply. In more contemporary research, increased military spending is viewed as a driving force behind business and economic cycles. There is even a school of “long-wave” theorists. The



Russian economist Kondratieff, who created the long-wave theory in the early 20<sup>th</sup> century, argued that the three major economic waves he had discovered in modern history were all centered upon major wars. [Ref. 23] The scientific explanation is that when defense-spending levels are high, an economic rise is observed. However, over time this inevitably leads to a decline in output resulting from the shortages of the various factors of production. Increased government spending for defense takes the “lion’s share” of goods and services, draining them away from the aggregate consumption, leading to a higher ratio of demand to supply and hence, to higher prices. More recent research also emphasizes the correlation between increases in military expenditures and increases in wealth. [Refs. 24 and 25] These papers should be considered renewed points of views based on both the “long-wave” and Keynesian theories.

According to John Maynard Keynes, in terms of economic performance, increased defense expenditures boost economies over the short term, but have detrimental effects in the long term. Politicians often manipulate the first part of these theories to justify increases in defense spending so as to counteract negative turns in the business cycles. In fact, the absence of private-sector investment, the disruption of trade, an increase in the money supply, and the expanded allocation of the factors of production for defense significantly undermine economic growth.

Robert E. Looney and Peter C. Frederiksen note that, although “the military spending level of any nation is likely to be the product of a number of separate forces”[Ref. 26] such as arms races, military alliances, military aid, the form of government, etc., much of the recent research has focused specifically on the role of economic variables. [Ref. 27]

Scholars try to answer challenging questions on whether and how a change in defense spending causes a change in economic performance. Different countries use the different elements to measure defense spending. However, national income accounting is more reliable in some countries than others. Defense spending numbers remain unreliable in developing and transitional countries.

## **B. THE DEFENSE BUDGET**

...expenditure depends on policy

Disraeli, 1862

...one cannot speak of “better” budgeting without considering who benefits and who loses or demonstrating that no one loses

Aaron Wildavsky

Defense in particular is cheaper for giants

When small is beautiful  
(December 18, 2003, From the Economic printer edition)

The proper size of the defense budget is based on the State’s international and domestic political, economic and social goals, on its multifunctional character, and the permanent trade-offs for producing “butter vs. guns”.

The defense budget consists of programs funded for ensuring the state’s ability to defend the country and protect national interests. The defense budget also has a significant domestic impact. Its size and composition may affect the health of the economy, and the level of defense spending is often a major debate issue concerning national priorities.

### **1. Constitution, Law and Transformational Changes**

The development of the foreign policy of the State is normally viewed as promoting generally accepted national values while taking into account the context of relationships with the major actors in the international arena. These national values are defined as the most fundamental principles on which the social, political, and economical existence of the state are based.

Georgia is an independent republic. Its Constitution and law declare democratic governance, supremacy of law, and the principles of free market. The Constitution defines the norms and regulations that rule the management of the Ministry of Defense.

Recently, Georgia attempted to establish democratic control of the Armed Forces. The main reason is to transfer all the mechanisms of management and control of the Armed Forces to the civilian leaders of the Armed Forces. The State establishes and represents the foundation for civilian control. The President as supreme commander exercises civilian control and management of the Armed Forces. The Minister of Defense is an appointed civilian leader and member of the government who manages and controls the Armed Forces through the Chief of General Staff. Civilians hold the leading positions in the Ministry and are subordinate to the minister.

The basis of the main activities of the Georgian Armed Forces are operational principles, such as:

- Unified Vision;
- Coordinated Efforts toward a common vision;
- Simplicity;
- Flexibility
- Dominance of the operational goals over the support goals;
- Coordination of Defense Plans.

Transformational processes are now in place to attempt to integrate the Ministry and the Joint Staff. The integrity of principles and goals assures the efficient managerial structure. Observing the operational principles also make the integrated Staffs and Armed Forces more effective.

Currently, Georgia's political leadership lacks an integrated vision of the main goals, especially a hierarchy from the top national leaders down to the unit commanders. National goals should be identified. Then, efforts should follow to ensure the realization of common goals. Furthermore, structures built on the principles of simplicity and flexibility will allow the Minister and the Joint Staff to adapt to changes easily in both peace-time and wartime as well as in transitional periods from peace to crisis, and from crisis to war conditions. The focus of integrated structures should be concentrated on operational goals and objectives. An effective organizational structure should be documented which reflects the goals of the existing forces and consequent resource allocation for the priorities and the main line defining the staff-members' accountability.

## **2. Implications for Defense as a Public Sector Agency**

The Ministry of Defense should be seen as a Public Sector Agency. Public sector organizations are often constrained and/or directly influenced by political considerations. A related issue is that public sector organizations are more accountable for their decisions to outside parties and often to the public in general than private organizations. Decisions by managers in such organizations will often be taken in the context of political/regulatory requirements. Public sector organizations are often very formal and bureaucratic, and for this reason, may often be slow to respond to change.

### ***a. Organization's Direction, Design Factors and Culture. Outputs and Outcomes***

The organization's direction is one level for system adaptation to the environment. The Ministry of Defense is a state agency, and consequently, is an example of the "shared power" system of governance. The internal environment generally reflects public expectations and national policy-making.

In a turbulent political and economic environment, leadership of the Georgian Ministry of Defense has failed to overcome the greatest strategic management challenge, that of building a consensus on agency direction! It could not devise and frame an agreement on the organization's direction. As a result, for a long period of time, the MoD tried to develop with decreasing budgets.

In the National Security Concept, strategic directions often were determined in a chaotic way and were not linked with funding. Strategic evaluation was narrowed and limited to paid salaries only and reports to the government. Failure to reach an agreement on what direction the agency should pursue has resulted in stagnation of the reform processes and under-utilization of the real "delivery capacity" (i.e., historical Georgian traditions of having a skilled Army). Consequently, management problems arose.

Institutional processes are characterized by decentralization of workflow in an uncoordinated manner. This is contrary to normal theory, which states that units should work in sequence. Coordination and timing among units is necessary. Coordination should be done by planning. Thus, sequential interdependence is desirable for the organization.

Both the Minister of Defense and the Chief of General Staff have had limited authority to integrate all elements of the program. Organization management is centralized and decentralized at the same time. The Defense Ministry, like many state agencies, is a heavily matrixed organization, and therefore, it is not an easy task to create straightforward lines of authority.

The financial management process is the most important step to interrelate plans and resource constraints. The main task of the process is fitting the tasks and real numbers of personnel, equipment, ammunition, etc. to constrained financial resources. However, execution of the budget is often fragmented for specific services and units.

Human resources management should determine the optimal size of the personnel force. Constrained financial resources normally force the organization to downsize the workforce, and outsource various infrastructure and acquisition responsibilities. Failure to do so has caused limitations in training programs.

Organizational communication was oversimplified. Conflicting opinions often were disregarded. Fragmentation occurred in decision-making between the Ministry and General Staff, between the General Staff and tactical units, and between different programs.

Outsourcing and contract consolidation as the way to improve the organization's efficiency was part of the solution in terms of constrained resources, but this was not set as the main financial managerial task throughout the agency.

MoD as an organization should have created its own culture. Under political pressure, the organizational culture has become compromising and dysfunctional. Irresponsible attitudes and approaches of various structural units and systems were characterized with increasing deviations from expected performance.

Actually, the government did not create a set of expectations. General tasks and goals of the Armed Forces were not consistent with available resources. Under this “to give in to report” culture, the organization could not fit into the larger environment full of internal and external threats.

Despite the fact that the organization experiences many shortages and limitations in proper management, do not underestimate the output(s) and the outcome(s) of this organizational system. It has a significant output: a very specific product, i.e., a public good. The Armed Forces is considered a tool for defending national interests. Acceptance of higher risks to satisfy stakeholders’ requirement that the defense programs be economically justifiable while at the same time providing the most important defense capabilities is a continuing and difficult task.

Output measures or metrics of output gradually depicted the rush for the “approved size of the Armed Forces”. In fact, there was only enough funding for the officers’ salaries and feeding the soldiers. Training and combat readiness were not at all considered an issue of great importance. Time and variance in the units’ training and tactical operations was often considered not from the strategic standpoint, but mostly from current political complications with neighboring countries. The “just-in-time” approach to operations planning caused this variance.

Outcome measures of the existing organization are very complex and consist of a number of standards for combat readiness. Measuring the final outcome or degree of achievement of the desired objectives is considered almost impossible. Only the outcome (result) of war could serve as that reason, “...the ultimate test of military effectiveness is war” and it is an “unacceptable prospect”. [Ref. 28] Outcomes, unlike outputs, are not principally within the possession of an agency, but depend on conditions beyond its control.

#### ***b. Organization’s External Environment***

Public sector strategic management requires the analysis of an agency’s environment, devising its direction, and the implementation and evaluation of that direction.

Organizational survival and success depends on wise managerial decisions of converting environmental inputs into organizational outputs, i.e. on effective throughput.

For this thesis, the strategy of adjustment and methodological adaptation to the environment was changed to “conformism”, and nobody in the organization tried to protest against the vicious cycle of defense funding from year to year. The Armed Forces were just physically surviving. The U.S. EUCOM assessment from 2000 and 2001 indicates the very low level of readiness of the Georgian Armed Forces, rooted to some degree, in its history and culture.

Almost two centuries before regaining independence in 1991, Georgia had no chance to control its own defensive forces. For the last 70 years, Georgians served only in the Soviet Union Armed Forces. No officer, except a Russian officer, received a promotion to higher ranks and positions. Soon after Georgia regained its independence, no ready model for building the Armed Forces existed. Actually, the organization started its existence from the loss in Abkhazia. After the war ended, Georgian officers from the Soviet Armed Forces and former civilians formed the Georgian Armed Forces. These relations, however, were very complicated. The two groups did not trust each other, since no unity of ideas existed. The organizational culture based on the rigid approach of the former SU officers on the one hand, and behavior based only on “naked” patriotism and warrior ideals without any military background on the other hand, were absolutely contradictory. In fact, the loss of Soviet Forces gave birth to the unconscious fear of losing the principles of paternalism. There was no strong political objective to replace it, and no internal transformational strategy. The lack of experience and skills to manage the organizational system independently made it difficult to obtain budget increases.

Normally, the political and economic environments act in unison. However, rather than adjust expectations to the new realities of downsizing forces and making them more mobile and well-equipped, the leadership continued to push an agenda that included the development of larger Armed Forces.

The external environment was often changing with mandates and priorities. Government leaders issued different, fragmented, sometimes contradictory mandates for the organization. The mandate such as “high readiness of the forces” was seldom supported by appropriated funds. Reconciling the conflicting interests of the Ministry of Defense, Ministry of Finance, Ministry of Interior and other related agencies was a challenging task. Contradictions between goals and interests of different stakeholders were apparent. Throughout its history, the Georgian Armed Forces have not been able to work together in acquiring clear strategic mandates from the government, formulate appropriate programs, and adjust them to constraints and changes in the budget.

The budget is a strong indicator of the priority the national political leadership assigns to a federally funded activity. By that criterion, defense activities have not been high on the list of national priorities. In the Constitution, there is no provision for funding emerging situations. Presidential orders regarding “finding out” and distributing “additional funds” were issued when some threat from the outside or even committed acts of aggression were occurring.

The MOD budget constituted only 1.7 percent of the GDP and 4.0 percent of the state budget. Faced with this budget situation, MOD had the choice to either downsize the forces or maintain them at a “survival level”. Agency leaders chose the latter. This decision was partially dictated by the justified fear of further decreasing the budgets in accordance with the smaller forces. Defense leadership has failed to draw the line between the external and internal environment, to keep the organization in equilibrium with its environment, and to balance between the various influences on the agency and its general strategy. There was a lack of effort to make adaptation to the environment less painful.

In analyzing MOD’s organizational system framework, it is apparent, that the system’s inputs, throughput and results often do not fit with each other. For example, the historical environment often forces misleading trends in choosing the design factors. Often-changing mandates and the larger environment negatively affect the culture.



Performance measures are “artificially” increased at the expense of compromises in culture. Real outcomes do not correspond to the main mission and goals, and a mandate setting is not committed.

The natural circulation of the organizational system is “self-destructive”. Since the agency has no clear set (system) of strategic goals, outputs are not measurable, and as a result, no base (foundation) can be created for further development. [Ref. 29]

*c. Recommended Directions*

The most successful change in the leadership chain for overcoming the uncertainties and misunderstandings between the agency as a public sector organization and its stakeholders can and should be related to its culture. The culture itself comes from managerial decisions on how policy directions and design factors will interact. Top management should create the traditions of more accuracy in planning, programming, budgeting; and maintain forces that best use available resources. Optimal size and trainings of the forces should be established and maintained as a main output. Although training schedules are an important management tool, those schedules must be regularly evaluated to ensure that any additional complication incurred to meet the schedule is recognized, understood, and acceptable. Planning and political fluctuations of the new state should be reconcilable.

Inside the process/subsystem link, human resource management is important. To cover the current gap in expertise transferred from the older generation of officers to the newer generations, the MOD should implement an expanded training program. This urgent need led to the Government decision to ask the U.S. Government for assistance in training and equipment of the Georgian Armed Forces. The Georgian Training, an Equipment Program (GTEP), began in 2002 and successfully trained more than 3,000 soldiers and officers (6 battalions).

The organization needs a higher degree of certainty to which decision-making authority will be confined to the top echelons or specifically assigned lower echelon officials. This results in an increased concentration and centralization of power at the first stage of restructuring and establishment of step-by-step measures for decentralization in the future. This approach will build a disciplined, systematic attitude

to identifying, analyzing, and controlling changes throughout the cycles of the PPBS. Robert S. McNamara developed the PPBS to centralize control of DoD planning in OSD. The PPBS was based on the best management practices of a modern, large, industrial corporation. ...This led to a focus on three elements that provided savings and presumably, a competitive edge: cost effectiveness, elimination of redundancy, and process management. The process of centralized control was not acceptable and came under considerable criticism from the armed services. [Ref. 30:p. 2]

Thus, the PPBS entered DoD as a public sector agency from the private sector. Some positive characteristics of the system appeared “alien” to DoD’s culture!

The PPBS changed management’s understanding of the Armed Forces. Managerial decisions should consist of the measures on a) development and maintaining optimal force structure; b) conducting trends and risk analysis at the sub-system, system, and agency levels c) conducting integrated risk analysis in case of insufficient funding and budget cuts; d) testing and verifying combat readiness. Another important issue is budget execution and financial accountability of the agency. The very strict approach to these issues will straighten the strong interdependence and linkages between precise budgeting and accurate execution. “The key would be to ensure that each issue is high-leverage and expressed in output terms.” [Ref. 30:p. 4]

### **3. Planning, Programming, Budgeting, Execution System as a Tool for Defense Planning (Methodology)**

Defense budgeting presents unique challenges not faced elsewhere in the federal budget process, nor in budgeting for state and local governments

Jerry L. McCaffery, Lawrence R. Jones

Interestingly, research literature on public sector budgeting devotes sketchy attention to defense budgeting. The question about “guns and butter” comes from the period of the end of World War II and the Marshall Plan, which was the issue of vital interest in Europe at that time. Europe strongly demanded “butter” to physically survive and it needed to transition from “guns” to “butter”! In spite of the fact that increased defense expenditures cause long-term macroeconomic uncertainties and negative changes, it is unjustifiable to put this question to the judgment of the taxpayers. This

association encourages society to think negatively about defense expenditures as those expenditures take “butter” from consumption. If so, the defense agency as a public sector organization cannot expect sufficient societal support . In the macroeconomic sense, military spending in fact “narrows” the share of public consumption.

This uncertainty is understandable because many countries in transition use zero-base budgeting (ZBB). The changes made via ZBB are those recommended by program coordinators in their submissions, not those dictated by external considerations. ZBB prefers the subjectivity of the manager to the objectivity of the analyst. The risk of maintaining ZBB is very high. ZBB, designed to fit into the organization, requires no special skills beyond the organization.

National defense needs are not something isolated or from “another world”. They exist to counteract possible threats. The size of defense spending should not only be a military problem . Well-planned increases in spending based on programming principles will cause stakeholders to reach a consensus over national defense and budget goals. Only the planning, programming, budgeting, execution (PPBE) system compels agencies to question their own purposes and existence by demanding that they take responsibility for outcomes. [Ref. 28:pp. 12-15] The PBB system’s purpose is to overcome the fallacy that “more” equals “better”.

The main points of the PBBS cover:

- cost effectiveness;
- balance between commitments and resources;
- transparency;
- priorities and coordination.

Cost effectiveness means seeking alternatives for finding the best value for the money. The best-value-for-money solution meets the requirement at the lowest through-life cost. There is no equality of cheap alternatives and cost effective ones. The cheapest unit can be useless, and therefore, a waste of money. Cost effectiveness cares not only about the capability of the unit, but cost as well. The practices of defense agencies in many countries prove that civilians cost less than the military. Therefore, outsourcing is a

big opportunity for savings. The PPBS can also answer questions about the reasonability of cutting costs by reducing the staff. Firing the staff can be a cost effective approach if it does not delay the timing for too long.

Cost effectiveness analysis also deals with issues of awarding contracts on the basis of open competitive tendering. Generally speaking,

costs and results must be considered together. The costs must be judged in relation to the results and the results must be worth their costs in terms of alternative results that are foregone or displayed. [Ref. 28:p. 30]

The usual reason for continual defense planning crises is an imbalance between commitments and resources. This occurs for one of two reasons: a political desire for a defense posture which cannot be funded with money made available, or a political desire to retain defense roles and tasks which are now not affordable. Politicians should choose the right scale so the DRM Group could seek alternatives to ensure that the resource support is balanced between the programs before obtaining the additional funding. Therefore, maintaining the proper balance between commitments and resources helps avoid crises in defense programs, helps to choose appropriate scale and structure and analyses in various ways to satisfy requirements.

A transparent PPBS process sets clear procedures for budget planning. Therefore, society perfectly understands that the budget is reasonable. It eliminates the level of corruption. In other words, taxpayer's money will not be used improperly.

The Defense Resource Management Group should co-ordinate with almost all structural entities at MoD and the Joint Staff to prioritize the fields of programs for better understanding of their needs and wants. Frequently, different services (Navy, Army and Air Force) compete with each other over portions of the budget.

The attempt is to describe PPB as a system, taking into account the necessary differences in approach necessitated by the particularities of a smaller Armed Forces. There is not a single and unique PPB model for all countries' defense systems.

Comprehensiveness, complexity and the dynamic nature of the political, economic and social events in contemporary states make it unlikely that any single model will adequately fit all cases.

Environmental changes necessitate debates each year. The resulting plans and programs aim to make the main activities of the defense agency clear and acceptable to the constituents. Environment analysis dictates the major priorities and directions for further development. Long-term priorities create the bigger picture, describing general missions and goals for national security. The long-term general view serves as a foundation for short-term goals, which in their turn, serve as the foundation for determining a proper mix of people, equipment, capabilities, and funding to meet the missions.

***a. PPBE System Overview***

The PPBS is the decision-making process that defines national defense interests and threats, develops strategy to deal with them, produces the Armed Target Force structure, and presents programs with alternatives and budget estimations.

What does a PPBE system entail in general? The system is based on an assessment of the world environment. Strategy is developed based on threat analysis, future political, economic circumstances, technological advancements and resources available. Programs are defined to execute the strategy using hardware (e.g., the Defense Resource Management Model), human skills, capabilities, etc. A budget is developed to fund the approved programs.

Programs and budget are one-year documents. The planning phase comprises a wider scope and is more continuous in time. All three phases are overseen by the Defense Resources Board, which is chaired by the Secretary of Defense. The Chairman of the Joint Chiefs of Staff, other high-positioned leaders of almost all departments responsible for planning, analysis and evaluation, accounting, acquisition, policy, personnel, etc. work as the members. [Ref. 31]

***b. What Drives the PPBE Cycle?***

The National Security Strategy outlines the nation's defense strategy. It is developed on an annual basis and is submitted to Congress with the budget. The

President issues the National Security Strategy. The foreign policy and threat assessment described in the National Security Concept should be broken down into political, economic and military strategies.

The different governmental agencies design “their” part of the concept, i.e., political and economic aspects of the security strategy and plan the appropriate activities.

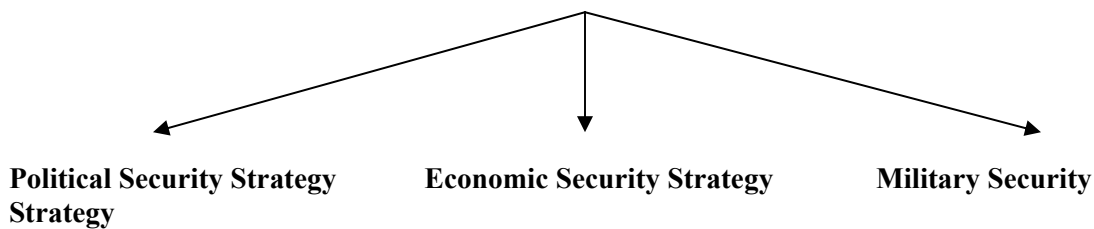


Figure 3. Components of National Security Concept

The National Military Strategy (NMS) is based on the President’s National Security Strategy by the Chairman of the Joint Chiefs of Staff. This document represents the overall planning guidance and is not fiscally constrained. It identifies strategic concepts and national military objectives, along with the Chairman’s Program Recommendations, and the NMS provides the Joint Chiefs of Staff guidance for the Secretary of Defense to draft the Defense Planning Guidance. The Chairman’s Program Recommendations focus on joint capabilities across the components.

The Defense Agency “supplies the threat of force, but foreign policy defines where force may be needed and risk assessments dictate how much force should be purchased through the budget.” [Ref. 32]

The important role at the beginning of the whole process is devoted to the Defense Resources Board (DRB), which oversees the entire PPBES process with the assistance of the Program Review Group. Deputy Secretary of Defense (Chair), Component Secretaries, Undersecretaries of Defense, Chairman of the Joint Chief of Staff and Service Chiefs work together on the board to review proposed planning

guidance, resolve major program issues, and resolve major budget issues. The Board advises the Secretary of Defense on policy, planning, program and budget issues, and proposed decisions.

The fundamental role in the PPBE system is devoted to the planning phase. The planning process begins at the Executive Branch with an assessment of the geopolitical environment. Strategy and policy for force planning guidance is developed and programs for applicability to strategy and policy are assessed. The planning phase has four outputs as documents on National Security Strategy, National Military Strategy document (NMSD), Chairman's Program Recommendation (CPR), and Defense Planning Guidance (DPG) as a final planning product.

Determining the composition of the force structure to counter threat capabilities is a decisive point in the PPB cycle. The programming phase determines optimal allocation of resources from an assessment of requirements balanced with fiscal constraints. Programming guidance is issued, distributed to the program managers and the Program Objective Memorandum (POM) as an output of this phase is designed. The POM updates the Future Year Defense Program database. This document and subsequent program review is the starting point for budget building. POM as an intermediate plan is the document of major importance, since it involves force structure, readiness and modernization decisions. The document outlines service plans to spend money and allocate resources. Subsequent POMs use the last four years of prior POMs as a part of the general scenario.

Programming is formally divided into two parts. The POM development process consists of Sponsor Program Proposals which are developed based on inputs from Commanders in Chiefs (CINC) who use their influence through an Integrated Priority List, Component Commander Issue Papers, and Baseline Assessment Memorandum that assess the funding requirements. In turn, the POM review process clarifies the Defense Resource Board's additional recommendations and deliberations, adjusts them to reflect the CINC inputs, takes into account service reclaims, drafts all the materials for making the decision and places it as the Program Decision Memorandum (PDM) of the Secretary of Defense. For the next step, the revised POM is delivered to the

Office of Secretary of Defense (OSD), JCS and CINCs to review the POMs. The Defense Resource Board reviews unsolved issues. The CINCs have another chance to make inputs and services have a chance to express their opinion on BDR changes to the POM. The programming phase of PPBES ends with final decisions on the POMs, and issuing them as the PDM. The PDM may require revision to the Budget Estimate Submission.

Budgeting consists of four steps: 1) budget formulation, which as a basis uses the POM adjusted by the PDM, budget guidance is issued, financial management regulations are designed (re-designed), budget exhibits are developed (programs are converted to appropriation format); 2) budget review tests how defensible and executable the budget is and if it is built based on the best prices, best schedule and principles of timely execution; 3) the OSD and the Office of Management and Budget (OMB) conduct a joint review and hearings to ensure that the DoD BES matches the President's strategy issues. The Draft Program Budget Decisions (PBD) are issued, which are the final product of the PPBS; 4) execution consists of first gaining permission to spend appropriations approved by Congress. After approval by OMB and the Treasury, DoD begins the process of separating and distributing shares to the military departments, services and other DoD commands and agencies. These claimants begin to incur obligations to spend, and then liquidate them through outlays of money. During the execution phase, comptrollers and budget officials at all levels of DoD monitor and control execution of programs and funding. If shifting money to areas of highest need is required, then military departments and services conduct a mid-year review. In September, at the end of the fiscal year, spending must be accounted for and all accounts are reconciled with appropriations. Conclusions about execution are followed by financial and management audits, the DoD Inspector Generals, the General Accounting Office and other structural entities. [Refs. 33 and 34]

#### **4. Specific Circumstances of Implementation of the PPBE System in Georgia**

It is possible to consider defense budgeting as a process in two different ways. One concerns Defense Budgeting in its narrow sense, meaning the fulfillment of Budget Estimation forms and submitting them to the Ministry of Finance. The other takes into



account the entire decision-making process that defines national interests and threats, develops strategy to deal with them, produces Armed Target Force structure, programs with alternative options and Budget Estimations. This is called the Planning, Programming and Budget System (PPBS). The principles and main idea of Defense Planning are approximately the same as in all Western countries, despite their specific features. Currently, Georgia is about halfway from Defense Budgeting in the narrow sense to a broader understanding.

The Georgian Armed Forces were formed soon after regaining independence. The independent state was required to manage the economy independently. In the Georgian economic system, some general understandings about the market economy already existed. There were progressive scientists working on these issues during the Soviet period. The situation, however, was absolutely different in the Armed Forces, which felt that nobody needed any changes!

In 1997, the Georgian government first officially asked the United States to provide advisory assistance on defense planning systems as it understood the importance of this issue for defense restructuring and modernization. The urgent necessity for overcoming the post-soviet mentality supposedly served as one of the main reasons for this decision. This was the first attempt at transparency of military budgeting in Georgia. That year, a program for Advisory Assistance from the IDA (Institute for Defense Analysis, Washington D.C.) was launched. The thawing processes of the locked, “secret” and “untouchable” system of the Post-Soviet Defense Economy have been started.

Historically, Georgia, like other Soviet republics, has had “no need” to plan the development of its Armed Forces since everything was centralized. During the Soviet period, resources (human, material, financial) were “unlimited”. Needs for defense resources were submitted to the government only based upon total requirements from influential Russian Generals, who thought that it was not necessary to control defense spending. Actually, it was impossible! The military were confident that the civilians “had nothing to do with military affairs.” This mentality surfaced because of the prevailing ideology in almost every Soviet republic.

It was not accidental that efforts for changes and reforms were made mainly in the planning and financial branch of the Armed Forces. The PPB system brings cadres of analysts; people whose first loyalty is to their discipline and data, not their agency. Analysts had no responsibility other than to question what the agency is doing, and their outputs and outcomes. [Ref. 28:p. 12]

As expected for that time, U.S. experts were put in unbearable working conditions. No permanent, stable group was created, which would step-by-step realize and implement experts' recommendations. The leadership of the MoD did not even try to become involved in the process. One thing was clear for the high-ranking officers: reform was aimed at transparency of the defense expenditures and their analysis. They could not get used to losing the power of holding all the information. Silent aggression and distrust from their side, and consequent discrediting of the initiative caused program conservation or cancellation. Only the 1999 program was renewed with the coming of new leadership in the MoD. This year is considered as the starting point of the Georgian defense economy. After creating the Defense Resource Management Group as a permanent structural entity, the first draft military program budget was submitted to the government in 2000.

*a. Understanding the PPBE System from the Beginning of Its Development and Implementation*

The PPBES includes the entire cycle of defense resource management. It enables the display of almost all negative and positive facts, planned changes, as well as successes and failures in the reform processes. Analytical abilities of the system often create the basis for positive transformations. Defense resource management, first of all, implies a need to create a complete information base. The PPBES requires the concentration of information on the structure of the agency, the authorized and actual number of personnel, the number of equipment, and types of combat techniques and armament. In fact, the issue about the database was the painful point which made the beginning of the assistance program in 1997 unacceptable to most of the high-ranking officers. By 2000, the database was built, and was easy to update. The database enabled the Minister to issue guiding directives for each fiscal year. The fiscal year in Georgia starts on January 1<sup>st</sup>. The State's National Security Concept and Strategy, threats, and

consequent military aims and missions should serve as a foundation for the priorities in the draft guidance. Georgia's National Security Concept has not been adopted yet, nor have other strategic documents, which should follow the National Security Concept. Only recently has Georgia's new government devoted serious efforts to crafting, accepting and approving this document. During 2001-2002, the MoD used the Defense White Paper as a basis for defense planning. Common military education and training plans were drafted annually. They then were passed to the lower (administrative, General Staff, logistic, etc.) units for familiarization and composition of their own missions. They compile their needs and paperwork, which goes back to the defense resource management department for further review, correction, and editing. These plans reflect priorities for maintaining the functions of the Armed Forces in defense of the state. Priorities and resources needed for their accomplishment are assembled as programs. Programs consist of a set of human, material and associated financial resources for each year. This is a simplified way to the budgeting process. If this sum of the programs exceeds the general ceiling as it normally does, the defense resource management department continues work on alternative versions of the budget for the Ministry and General Staff. Each alternative focuses on different programs and sub-programs. For example, because full funding is impossible, one version of the budget project makes a significant cut in the Air Defense System Creation program and the second version cuts the Rapid Reaction Forces Creation program expenses, etc. The DRM department thus fulfills its main function of facilitating decision making for the leadership.

The Georgian PPBE system should reflect logical and tight relationships between the several documents and working processes, including: 1) National Security Concept; 2) National Security Strategy; 3) Missions and Goals of Georgian Armed Forces; Development program for the Armed Forces; 4) Determining the optimum size of the Armed Forces; and 6) The Defense budget.

Ideally, the Armed Forces should have short-term (1 year), medium-term (5 years) and long-term plans and programs. Weak fiscal and economic institutions and conditions do not allow defense planning based even on a short-range macroeconomic prognosis. The Georgian government currently works on the country's financial strategy

and hopefully the defense agency will be assigned its percentage from the GDP, the State budget, and Central budget expenditures, etc. The Ministry of Defense needs to be able to plan in advance for at least the next two years.

***b. Resource Management (External Environment)***

A report, “Georgia: Public Expenditure Review,” prepared by the World Bank mission in Georgia describes shortfalls in the budgeting process. These shortfalls are part of the external environment for defense planning and implementation of the progressive system of wise management of resources in the defense agency.

The document indicates significant ambiguity and uncertainty in actual financing (allotting, disbursement of money from the State Treasury). Often changing circumstances in budget revenues are not the only reason for making planning and program financing impossible to formulate accordingly. Weak management of monetary circulation also plays a negative role. The Defense agency has long experienced the influence of the lack of clear principles in funding.

The World Bank report indicates a lack of strategic planning. Reviews of priorities are conducted but are not a priority or they are not reviewed at all. There is no strategic model for resource allocation. This fact creates a vacuum, which is partially filled with “protected” items (salaries, pensions, etc.). Protected items account for 85-90 percent of the Central budget.

The Ministry of Economy was the only public agency that attempted to define and review priorities. It required line ministry submission of plans in the form of state programs. On this basis, the ministry tried to compose the country’s indicative plan. Unfortunately, recent State budgets do not relate to those plans.

The retention of “protected” items for a long period of time causes many dysfunctions in the country’s financial system. It is completely unfair to the Armed Forces. Financing the defense agency under these principles resulted only in provisions and supplies for the manpower and personnel. The core activities and maintaining readiness and undertaking modernization (R&D) remain unfunded! In this case, the spending of State funds cannot lead to the main reason of maintaining and strengthening

defense. In other words, budget resources are wasted. Budgeting only with “protected” items creates paths for financial violations and corruption: 1) often agency budgets indicate artificially increased amounts for “protected items”, hoping to obtain more appropriations for them. During the budget execution process, actual funding in most of the cases covers only “protected items”. However, after the agency receives them, it spends them for operational needs, such as training, office expenses, etc. At the end of financial year, there are serious misunderstandings between the Ministry of Defense and the Ministry of Finance about the records for actual expenses, i.e., budget execution issues. The submission of financial reports is normally delayed. The Treasury Department should follow the principle of “protected items”, but at the same time, funds are often re-authorized for other budget categories. This happens based primarily on the personal influence of the agency leaders. Controlling budget execution is very complicated, and sometimes even impossible. For the last period of Shevardnaze’s presidency, it became more and more usual to fund only salaries and food for the soldiers, i.e., protected categories for avoidance of social disorders.

One of the main points of the World Bank report indicates that the so-called “protected items” hinder strategic budget planning. Based on the current definition of protected items, it is not easy to link them to clear results or outcomes. Besides the protected items, amounts in the budget are too small to manage “under circumstances”. This makes the budget inflexible, especially in the short run. Organizations have no stimuli for saving money. The rationalization of personnel and reallocating of budget funds should be on the agenda, allowing a link to all State expenditures to the line ministries’ goals and programs.

Using “protected” items does not enable MoD to discuss missions, goals, and rationales during the budget review process. This issue simply does not occur. The review process is limited to one particular “upper boundary (ceiling) figure,” which normally is the same as the financial needs for personnel category expenses only. The long time leadership of the Ministry was very careful about the realization of the International organizations’ recommendations regarding downsizing the number of personnel, and improvements in the level of readiness. If the Ministry had taken actions

for downsizing, this was considered a real threat to the proportional decrease in funding based on the protected items practice. Starting from 2000, the MoD created the foundation for building the budget according to the missions and programs by moving to the PPB system. The agency can demonstrate accordance of its budget to the State's strategic goals. However, even in 2002, officials at all levels of management had reservations about the “too early” progress of MoD toward complex and transparent budgeting, and were referring to the weak financial and economic system. For example, when the MoD first submitted a military program budget, copies of the draft remained in the office table boxes of the political authorities. The attitude was as usual: “It is no time for the experiments yet!”

The WB paper indicates the existence of another characteristic of unhealthy public expenditures management in Georgian reality: a weak or nonexistent relationship between what is budgeted and what is actually spent at the program level. This makes the budget less credible. Rather than looking for problems in budget execution, reformers need to look at the relationship between policy making, planning and budgeting. The more changes experienced between appropriations and actual spending, the less reliable the budget.

These weaknesses are not new. In 1980, Caiden wrote: “If ever there was a subject which has been overwritten, overanalyzed and over theorized with so little practical result to show for the effort, it is budgeting in poor countries.” [Ref. 35] A Georgian Defense White Paper notes that there is no financial State strategy with identifying planning parameters for MoD. This results in the incomparability of the planned and actual expenditures.

“In a poor country the ministry of finance has but one role – to say “no.” If the nation is not to go bankrupt, nor to sink into inflation, not to run out of foreign exchange, the finance ministry must limit expenditures in relation to available revenues; “how much money is spent, rather than the purpose for the expenditure, is the first concern. The economic merits of expenditures, although they receive some attention, are secondary.” [Ref. 36] Saying “no” often results in mid-year cuts of the State budget,

which negatively affects the realization of defense programs. Hicks and Kubisch found that in countries where real government expenditures declined, the defense sector was more vulnerable to cuts than, for example, was the social sector. [Ref. 37]

The World Bank report summarizes the public expenditure management situation in Georgia. The process of State budgeting does not identify and provide the functional priorities. Macroeconomic forecasts differ from one agency to another. Each ministry identifies its own requirements. The entire government does not support the state budget. The Ministry of Finance defines the appropriations. There is no clear structure of expenditures. Line ministries are not responsible for planning and programming their activities in accordance with assigned funding. Even protected items are planned for the short run. Existing practices for budget building do not provide a satisfactory basis for identifying priorities and strategic appropriation of funds. The current system exacerbates the tendency of moving funding from operational to salary needs. Priorities drafted by foreign donor organizations have the greatest influence on the budgeting process. The government only reacts; it does not play the role of initiator.

It is not reasonable to automatically transfer the general idea about protected items to the Armed Forces. The Armed Forces as an organizational system with its final product of output, which is defense of the state based on permanent improvements in combat readiness, relies on the following.

Table 5. Resource-Process-Output System in GAF

<b>Resources</b>	<b>Process</b>	<b>Output</b>
Personnel – X funding Operational Readiness – 0 funding Modernization – 0 funding	Improvements in combat readiness – 0 funding	Defense Ability of the State
<b>X+0+0</b>	<b>0</b>	<b>0</b>

As shown, zero funds allocated to Operational Readiness and Modernization results in zero improvement in combat readiness! No value is added!

***c. Steps Forward in Defense Planning Reforms (Implementation of the Simplified U.S. PPBES Model)***

According to the recommendations and active practice of receiving advice from IDA experts, the Defense Resource Management Study was chosen as a starting system on the way to using PPBES. Attention focused on the following characteristics of DRMS:

- Contribution to effective civilian control. Normally initiative and demand for making the Defense Budget more open, clear, transparent, and acceptable comes from the civilian sector and agencies. In Georgia, the Ministry of Defense (MoD) initiated general reforms starting with core changes in defense planning and budgeting. This initiative was not really supported by the government of that time. Dysfunctional state institutions, a corrupt public sector, and different interest groups were opposed to this kind of reform. The legislative branch did not want to vote, and thus take responsibility for defense programs. It preferred to stay in the shadows.
- The multi-year perspective is the potential theoretical and practical strength of DRMS, but during its existence MoD always has had problems in attaining a clear final financial target, even for the following fiscal year. No state document establishes the percentage of MoD's Budget from the GDP or state budget. For example, NATO requires its candidate and PfP countries to plan 1.8-2.0 percent of their GDP for defense expenditures. However, there is no strategic document in Georgia directing a percentage of the State Budget. Thus, it is impossible to create realistic long-term (10-year) or mid-term (5-year) defense programs.
- Broad participation. First, DRMS for the Georgian Armed Forces (GAF) served as the path to mental interoperability with Western standards. More and more commanders and higher-ranking officers started to be involved in the DRM Study. Now they have a clear understanding of the value of this system. DRMS is a strong incentive for all parts of MoD and the Armed Forces to think about military objectives, and associated resource needs.
- Transparency of the Defense Budget is an important part of Civil Military Relations. Progressive forces in the Georgian government were mature enough to review the military program budget, but there were serious barriers because of the unstable political and economic environment. The Government did not take on the responsibility to vote against military expenses for several very important programs or program elements, which were to remain unfunded.
- DRM study clearly relates to:

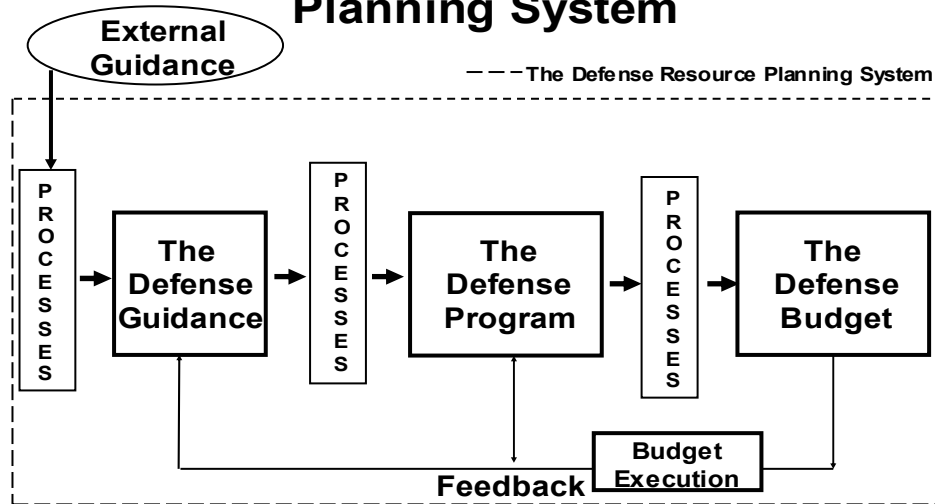


- national military objectives to capabilities required: countries in transition often have no approved military objectives to identify required capabilities;
- capability acquired and maintained to resources required and expended; transition countries have difficulties in making economic prognoses for resources.

It is clear that many advantages of DRMS were lessened by current realities. It was difficult and sometimes impossible to achieve the promised advantages.

From the beginning, the key components of the new DRM system were identified. New teams working on system implementation issues realized that Ministerial Guidance would have to address the National Security Strategy, the Defense Concept; Military objectives with timing and priority, programming instructions to program managers; and resources available: manpower and funding. The next step is to craft a multi-year defense program that relates resources required to capabilities needed to satisfy Guidance. Then, planners build an annual defense budgets that describe the resources needed to realize the approved program. To attain these objectives, MoD needed a reform process consisting of activities, such as: 1) design of a new Defense Resource Planning System, with appropriately trained people to operate it at the ministerial level; 2) trained personnel in the General Staff and services to implement them at those levels; 3) Conducting an initial planning cycle; and 4) improve the new system with each subsequent cycle. A very simplified model for the cycle appears in the following figure.

## Elements of a Defense Resource Planning System



2

Figure 4. Elements of Resource Planning System

The Typical Structure of Defense Planning Guidance was drafted as follows:

- Strategic Setting
- National Security Concept
  - Summary of national security objectives and strategy
  - Summary of national military strategies
  - Identify missions of the Armed Forces
  - List key assumptions that may affect planning
- Planning Guidance
  - Program goals, objectives, their priority and timing
  - Resource constraints
- Administrative Instructions

During the first year, partial success was achieved. Ministerial Guidance was developed and approved, initial programs were developed and reviewed, but they had limited impact on subsequent budgets and limited opportunity existed to train personnel outside the DRPG.

During the second annual planning cycle, Ministerial Guidance was approved and distributed to program managers; Program Managers worked with the DRPG staff to prepare the 2002-2006 programs. At that time, program management offices lacked the experience needed to develop credible programs and the capability to estimate program costs realistically. Despite the obstacles, a 2003-2006 program and alternatives were developed by DRPG, with assistance from program managers. A program review took place and an approved program was converted to an annual MoD budget. The major challenge during that planning cycle was to achieve a proper balance between force structure and readiness, within the framework of the larger military reform effort and anticipated resource limitations.

In 2001, clear guidance objectives, priorities and timing were used for the first time during the planning cycle. Objectives were divided for short- and long-term periods.

Table 6. Guidance Objectives, Priorities and Timing Used During the Planning Cycle

<b>Near-Term Period 2002-2006</b>	<b>Long-Term Period 2007-2011</b>
<ul style="list-style-type: none"> <li>• Reorganize and reduce the size of the Armed Forces; improve the social conditions of military personnel.</li> <li>• Improve the professional level of officers, sergeants and non-commissioned officers. Improve readiness</li> <li>• Make improvements to existing infrastructure; establish minimum levels of war reserve stocks</li> </ul>	<ul style="list-style-type: none"> <li>• Maintain required levels of readiness</li> <li>• Begin modernization of major weapons and other equipment.</li> <li>• Improve infrastructure.</li> <li>• Continue to build the war reserve stocks</li> </ul>

Some implementation problems occurred. The Armed Forces were undergoing major, MoD- and General Staff-wide transformational processes at the same time that the resource planning process was being reformed. In addition, serious uncertainties existed regarding future plans and senior management's focus was divided between those two major reform activities. The result was that the lack of clear and stable

financial guidance and support from the Government; the lack of resource planning experience in MoD and Armed Forces; and the lack of a good management information system, were delaying the reform process.

The unwillingness to change the structural design of the MoD significantly hindered the process. Parallelism in functions and a desire to keep old paths and channels to access information and cash has also resulted in discrediting and hampering of the reform processes, e.g., until last month, MoD kept two old and new structural entities dealing with planning issues. Very weak ties between services and subordinated military units did not allow the DRM department to involve all levels in the process.

These and other factors placed the decision considering leaving the U.S. assistance program on the agenda. It is impossible for the Georgian Ministry of Defense to underestimate the merits of having high-ranking professionals from IDA. Educational and moral foundations, built by them step-by-step made the members of the DRM team enthusiastic, which has made it possible to continue, maintain, and develop the PPBES implementation processes.

The 2004 budget should serve as a transition document and will allow only sustainment again. Insufficient funding still exists for development in the current year.

For the first time, the Minister of Finance provided somewhat firm planning figures. (See the table below). This allows the execution of realistic planning in line with Ministerial guidance.

In addition to the cash allocations in each year, a donation of material resources will be made from various friendly countries. These donations are very much appreciated, but they will not alleviate the pressure on cash budgets, as none of the items donated were included above the funding line.

Table 7. GDP and Budget Dynamics

Year	GDP	The budget proposed by the MOD	GDP %	Special incomes of the GAF	GDP %	The budget, that includes special incomes	GDP %
1	2	3	4	5	6	7	8
2001	6 800 000.0	69 700.0	1.0	2 307.0	0.03	72 007.0	1.06
2002	7 260 000.0	71 000.0	1.0	2 900.0	0.04	73 900.0	1.02
2003	7 960 000.0	129 300.0	1.6	6 500.0	0.08	135 800.0	1.71
2004	8 900 000.0	67 000.0	0.8	0.0	0.0	67 000.0	0.8
2005	10 400 000.0	104 000.0	1.0	0.0	0.0	104 000.0	1.0
2006	11 400 000.0	148 000.0	1.3	0.0	0.0	148 000.0	1.3
2007	12 500.000.0	200 000.0	1.6	0.0	0.0	200 000.0	1.6
2008	13 750 000.0	275 000.0	2.0	0.0	0.0	275 000.0	2.0

As previously mentioned, it was difficult for the Government to assess with accuracy and confidence the level of funding available for public sector spending. It is clear from the following tables and figures that even when a budgetary allocation is agreed upon, it is often not received. Funds are allocated on a monthly basis and there is little confidence that the funding levels required to meet the operating costs will be met. There are also strict limitations on the reallocations of funds between spending categories, and this exacerbates the monthly under-funding problem.

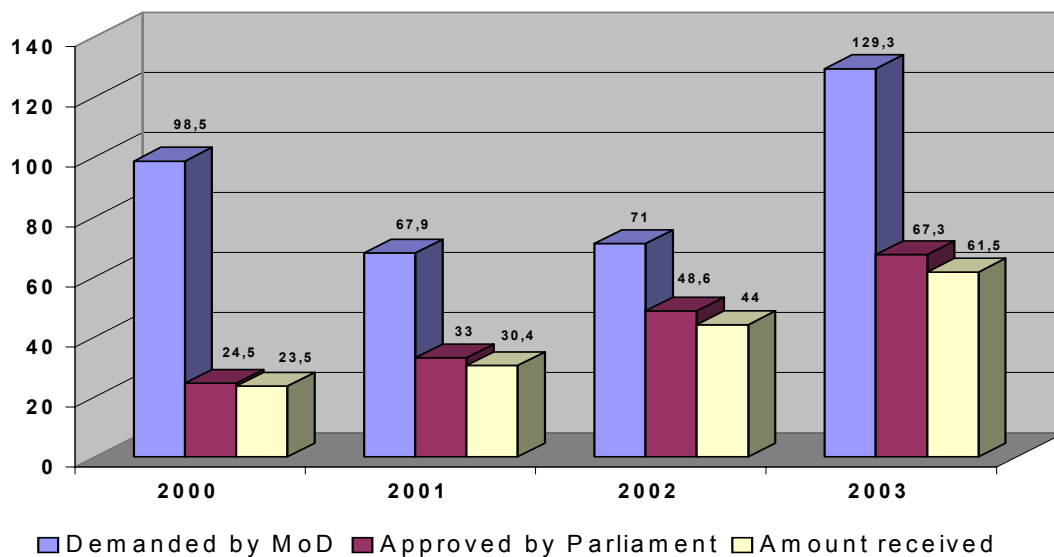


Figure 5. Defense Budget Parameters (GEL, mln) (2003\*-- 9 months)

The new system already possesses a maintained system, under which expenditures for the programmes are divided into three categories:

- Personnel;
- Capability (combat readiness)
  - ammunition storage and training expenses;
  - unit support (running costs)
  - development (including infrastructure and modernisation).

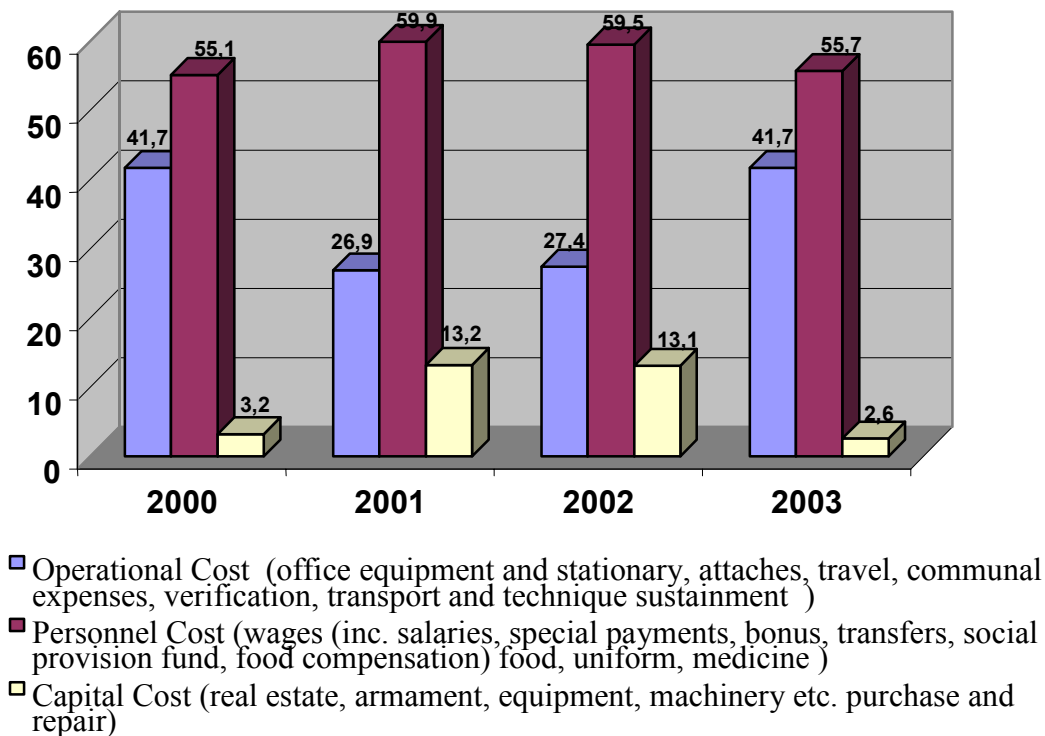


Figure 6. Defense Outlays by Categories

In FY 2002, MoD first attempted to make clear cost assumptions for identified programs.

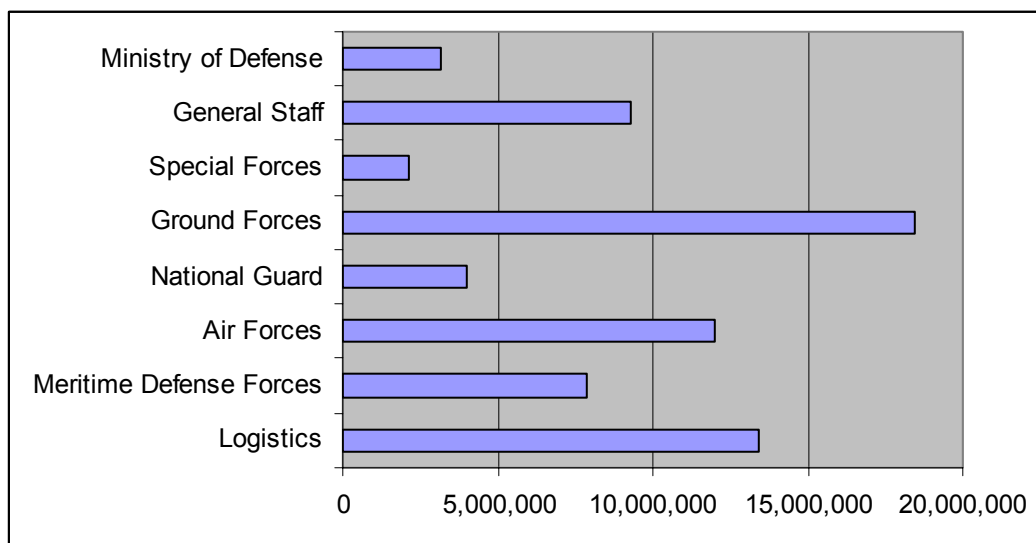


Figure 7. Resource Allocation among Programs

Resources were allocated also by expenditure categories for each program.

	Personnel		Capability		Development	
		%		%		%
Ministry of Defence (Admin.)	1,308,504	41.3%	1,862,527	58.7%	0	0.0%
General Staff (Administration)	5,607,574	60.3%	3,647,750	39.3%	37,000	0.4%
Special Forces	1,480,109	68.5%	680,907	31.5%	0	0.0%
Ground Forces	13,582,684	73.5%	4,888,264	26.5%	0	0.0%
National Guard	1,726,254	43.5%	2,242,428	56.4%	4,000	0.1%
Air Force	2,028,461	16.9%	9,968,285	83.1%	0	0.0%
Maritime Defence Forces	3,161,947	40.0%	4,735,570	60.0%	0	0.0%
Logistics	5,105,163	38.1%	1,871,153	14.0%	6,411,059	47.9%
<b>Total</b>	<b>34,000,696</b>	<b>48.3%</b>	<b>29,896,883</b>	<b>42.5%</b>	<b>6,452,059</b>	<b>9.2%</b>

Table 8. Allocation of Funds According to the Expenditure Categories

The following figure charts these expended categories for each program.

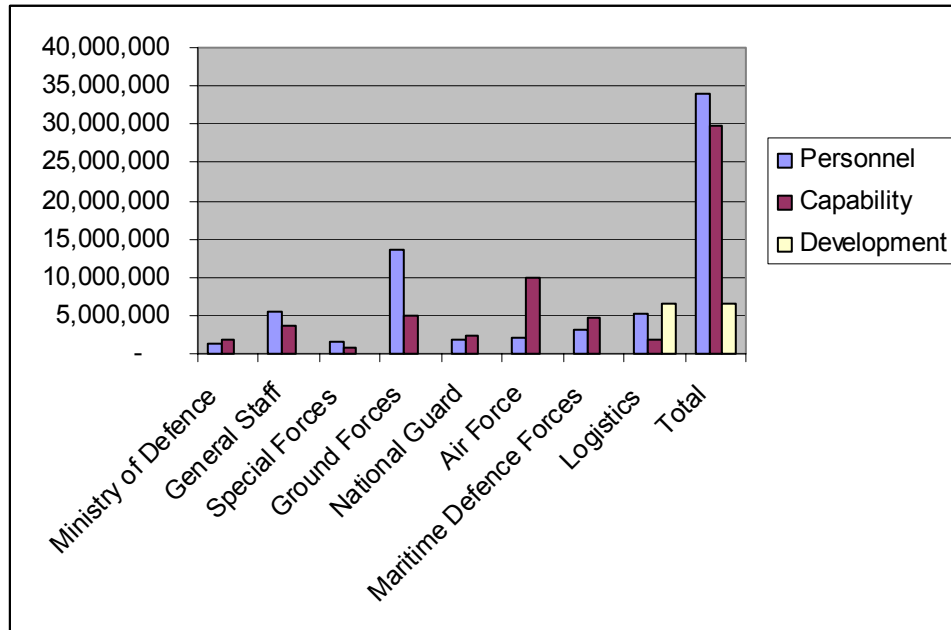


Figure 8. Allocation of Funds According to the Expenditure Categories

From 2001 until 2003, the submitted needs on investment were not approved in the military budget. There are now urgent needs within the development category. In the framework of general MoD reforms, improvements on the general rules for procurement are necessary. Several versions are being drafted.

Georgia officially declared its willingness to participate in the NATO Air Surveillance Data Exchange Program in 2001, and was approved by the North Atlantic Council in March 2003. Currently, work on the MOU between Georgia and NATO on Air Database Exchange is underway.

Funds are necessary to modernise old and procure new equipment. The main priorities are some kinds of equipment, transport and communication. Significant expenditures are necessary to create a minimum-level war reserve and strategic reserve and to procure medical and other equipment. Within an infrastructure, there is a great need to improve housing and barrack accommodations. The training infrastructure is a second priority in this category. It is necessary to develop a network of training centres



and attendant facilities. It is crucial to improve existing training facilities. Conscript training, peacekeeper training, and reservist training centres must be in a common system.

Future plans for financial management system transformation in GAF require continued planning according to the PPBS cycle, the revised design of the system based on experience, continued education of resource planners in the Armed Forces and MoD, an increasing level of participation during succeeding cycles, and improving existing databases. Most important is focusing more attention on budget execution by reviewing MoD's financial management plan and developing recommendations for improving financial management during budget execution.

It is imperative to stress accountability, as it is the cornerstone of accepted budget concepts, and especially for PPBES. In its narrow sense, accountability means the tracking of expenditures. The PPBES goes further and attempts to use the budget for planning purposes and a greater measure of program control.

There is a very interesting link between the three elements: steady resource mobilization (and stable funding), high accountability, and high administrative control. These elements of PPBES complement and support one another. Resource mobilization allows realistic planning, programming, and budgeting, which facilitate precise budget execution and accountability. Administrative control makes information available on past expenditures and future needs, and is, in turn, a prerequisite for precise accountability. [Ref. 28:pp. 20-21] However, political unwillingness and the lack of skills necessary for proper accountability caused serious barriers to important transformations in the financial management system of GAF.

#### **IV. DRAFT PPBES FOR THE REFORMED ARMED FORCES**

As already mentioned, Georgia has faced daunting challenges since independence such as a politically tense environment, permanently declining living standards, and dysfunctional state institutions. It was, therefore, almost impossible to think about progressive transformational changes in any agency. In spite of these circumstances, MoD has overcome the prevalent stagnated attitude towards reform and created a strong foundation for implementing PPBES.

The new Georgian Government has recently undertaken structural and second-generation reforms, as stated in the IMF Country Report from January 2004. Optimistically, these changes will lead to further MoD-wide reforms, especially in the defense resource management system.

##### **A. INSTITUTIONAL REFORMS**

One of the most important measures of progress is civil service reform. There is a commitment now to reform the public sector thoroughly.

Fiscal consolidation is very important. There are many problems in both revenue and expenditures, and resolving them requires revising the tax system to optimize its structure. Also, more efficient tax collection will depend on improving the management of public enterprises.

In spite of all the difficulties in the fiscal and external sectors, monetary policy has been consistently careful and judicious. Maintaining low inflation and a competitive exchange rate through the country's National Bank made it possible to maintain overall macroeconomic stability and growth. Regulatory measures against money laundering and the financing of terrorism will further improve the environment for investments. Georgian state officials agree that improved management of budgetary resources and state property will be essential to meet the rising demands for delivery of social services and safety nets.

A more complete costing of reform will be necessary before it can be launched. The interim administration has signaled its commitment to broad civil service reform, including a rapid restructuring of the civilian part of the Defense and Security ministries, which would be desirable to realize the benefits of such an effort fully. [Ref. 38]

Formulation and execution of the main policy priorities is the key to success, and estimates are needed on the cost of government policies and programs beyond the budget year. Government level institutional mechanisms are needed to enable reprioritization and reallocation of the resources due to the changes in policy, and consequently in priorities. This foundation will enable better performance on the operational level. [Ref. 21:pp. 31-52]

#### **B. TRANSFORMING PPBES MANAGEMENT DESIGN FACTORS IN GEORGIAN ARMED FORCES: HIERARCHIES OF OBTAINING**

For a country such as Georgia, it is suggested starting with the most simple design, and adding detail and complexity only as development and improvements require through acquired experience. During the starting period of the transformational processes, the more senior people between the Minister and the people doing the work, the more problems will occur in terms of coordination, harmonization, etc. A draft design might be very “shallow”. According to the “basic” design, there are a minimum of three major functions that every MoD must to perform: Policy Development; Resource Planning and Management; and Procurement. The State Secretary should be in charge of three major directorates handling those responsibilities, and they report directly to the minister.

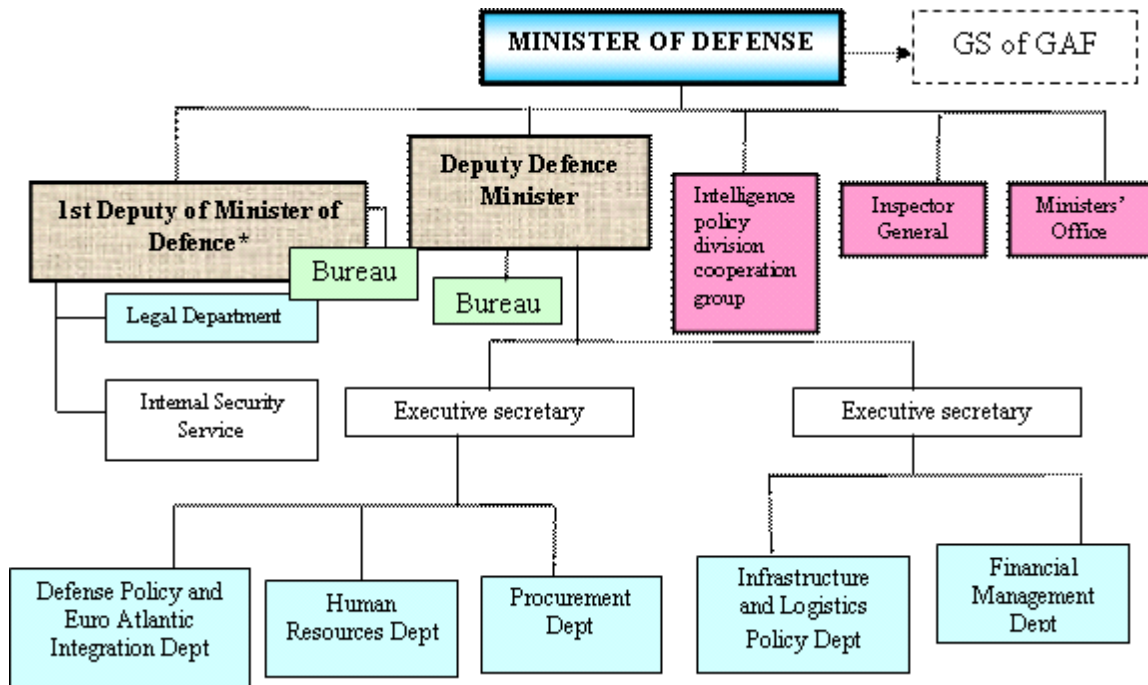
Under this system, the State Secretary for Policy is responsible for the Planning Policy to ensure that all planning in the MoD and Armed Forces is coordinated and mutually supportive. He is also responsible for the Human Resources policy and can also handle other “general” policy areas, such as “International Cooperation,” which may include NATO and Euro-Atlantic Integration. As the senior State Secretary, he also serves as the Deputy Minister.

The State Secretary responsible for Resources has control of all resource planning and execution management. All planning and execution management should be under one State Secretary, reporting directly to the minister regardless of the structure for handling resource planning and management.

The State Secretary for Procurement is responsible for formulating the specific policy that guides how procurement is executed within the MoD, and developing and executing the procurement plan concerning what will be procured, when and at what cost, that evolves from the MoD's resource planning activities, i.e., the budget.

Where should the procurement and financial management functions reside? Procurement should be under the same State Secretary responsible for Logistics and Infrastructure. There is a closer linkage between the identification of requirements (resources) this way than under the alternative. Moreover, since considerable funding is being provided to Georgia by foreign sources, linking financial management under the same State Secretary responsible for external affairs also appears to make sense. According to some recommendations, Financial Management should be under the same deputy minister as logistics. However, upon reflection, it is believed that it is better for the same State Secretary to be responsible for the logistics and procurement functions. What is clearly important is that the financial management and procurement functions be separated and do not report to the same State Secretary. There should clearly be a link between the Procurement and Logistics Policy, as life-cycle costs and issues are an important consideration during the procurement policy. One person with oversight over both these areas will ensure the consideration of the logistics aspects of procurement, and –thus, another rationale for this recommendation.

The following figure summarizes all these considerations for the recommended structure.



Note: (\*) The 1<sup>st</sup> Deputy Minister simultaneously executes functions of the Parliamentary Secretary. This structure is already approved by the President of Georgia on April 5, 2004

Figure 9. The Interim Structure of the MoD Georgia

### 1. Basic Hierarchic Levels and Their Structuring

In order to determine the financial architecture of the future system, it is necessary to define the main organizational levels and business groups, which generate and use financial information. Three levels can be distinguished:

- First level management, including the administration of MoD and GS;
- Second level management, including Financial Management, Logistics and Headquarters of Services;
- Working (operating) level, including brigades, battalions, warehouses, schools, and other structural entities, subordinated to the first two levels of management.

Initial attempts to implement PPBES show that the MoD and GS have the following business groups:

- Administrative, i.e., Main Departments and Offices, Executive Agencies, Services Headquarters, etc.;
- Combat (brigade (battalion level is still impossible to include in the process);

- Logistic (depots, warehouses);
- Educational (National Defense Academy, training centers);
- Medical (hospitals, etc.)

## 2. Organizational Structure and Scope of the System

### a. First Level of Management [Ref. 39]

Considering the necessary processes in the MoD, the managerial levels and business groups, the financial function and activities in MoD should be organized in the aforementioned hierarchic levels. For this reason, see the following suggested organizational structure [Ref. 40].

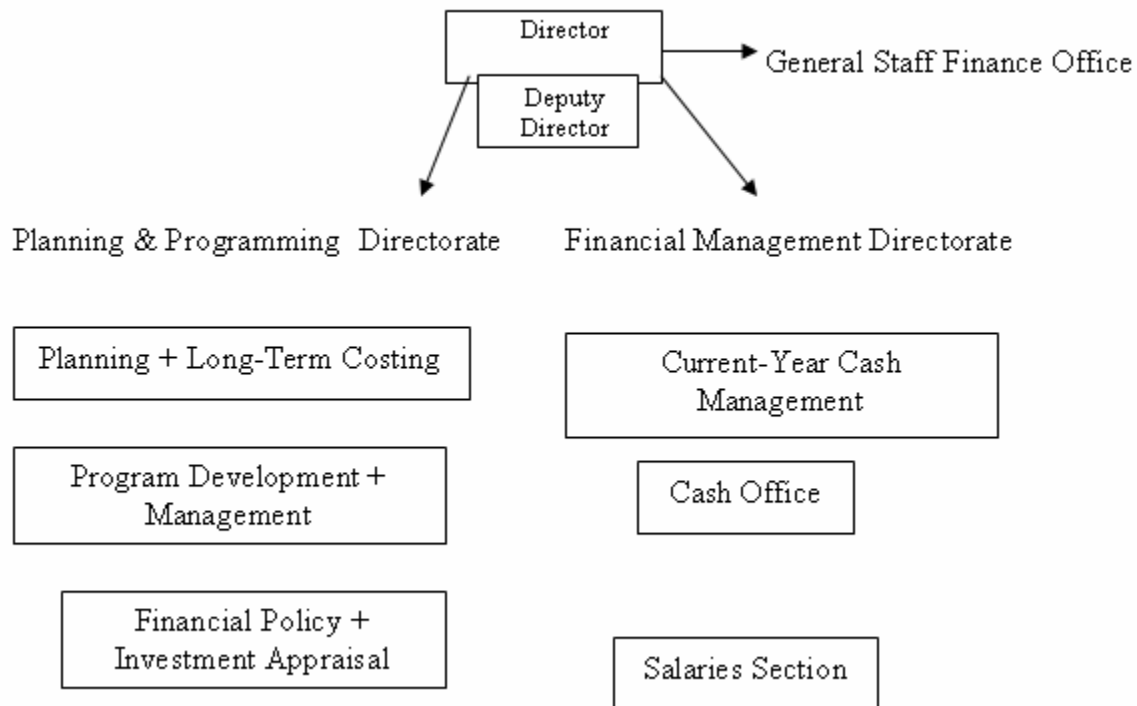


Figure 10. Simplified Structure of Financial Management Department

The budget Planning and Management Directorate shall have the following functions:

- Consolidation and analysis of data from all levels of the informational system in order to obtain a complete and accurate picture for budget execution, operating contracts, and expenses and payments;

- Creating and updating methodical guidance for lower financial levels in the MoD on financial and accounting activities;
- Determination of quotas (percentage limits) for each program, sub-program and program elements and preparation of budget;
- Consolidation of program elements budgets into sub-program budgets and program budgets;
- Analysis of possible outcomes for certain programs as a result of resources allocated;
- Participation in MoD project preparation, as well as proposals for investment projects;
- Preparation of the MoD budget into program and functional sections;
- Defending the MoD draft budget for the next year before the Ministry of Finance.
- Participation in budget allocation by programs;
- Control of payment limits at all levels of management, cost items and periods;
- Estimation and approval of demand for arranging contracts and taking liabilities;
- Maintaining databases;
- Analysis and approval of requests for supplies;
- Management of budget execution according to criteria;
- Analysis of trends in budget execution;
- Analysis of alternatives;
- Cash flow analysis;
- Analysis of resources spent vs. outcomes;
- Analysis of program execution effectiveness;

One first-order goal at this level is to educate second and third level officers to handle financial management tasks.

Necessary improvements in the budget execution phase should be focused on the processes which are the weakest in the Georgian PPBES. Georgia is attempting to move to the International Accounting Standards (IAS) and the accounting process should be performed according to Accountancy Law, National Accounting Standards, and all relevant legislative documents. This process should provide reliable and accurate

financial information for management of MoD and other state agencies. The fundamental accounting operations are performed at a working level. The information is communicated to the higher levels where it is consolidated. The process should ensure information interchanges with all other business processes.

Without a real desire for accountability, the MoD's financial activities will continue to result in waste, fraud and abuse in the various systems, including payroll, logistic supplies, contracting, maintenance, taxation, relations with the Ministry of Finance and the Treasury Department, inventory and accountability of real property, and so forth. Negative outcomes from these weaknesses may be classified as follows: 1) lack of reliable information needed to make sound decisions and report on the status of MoD activities, such as accountability of assets; 2) hindering operational efficiency; 3) adversarial affection on mission performance. [Ref. 41:p. 4]

Referring to the previous scheme, the functions and responsibilities are drafted for the financial management department. The new scheme aims to make the budget execution system simple, clear, and thus, transparent. The main reason for change is to overcome the “budget-holder” phenomenon: the senior financial official at the MoD always sought to “get money for the Ministry.” He was sure that accountability was “nobody else's business”. Actually, he considered himself a “budget-owner”. The reason to move from a vicious to virtuous accounting system will improve the final phase of the PPBE system, which in turn, will serve as a foundation for more successful accomplishments in the first three phases. The MoD needs to eliminate the following problems in current accounting practices: unwillingness of top-level leadership to correct problems, cultural resistance to changes, lack of results-oriented goals, performance measures, and monitoring; and inadequate incentives and accountability mechanisms relating to business transformation efforts. [Ref. 41:p. 9]

According to the new draft structure of the Financial Management Department of Georgian MoD, the Financial Management branch is responsible for in-year cash management; cash office; and salaries section.



The current-year cash management department issues cash allocations in line with previous one, manages all cash expenditures for the State Secretary, produces management information for the Ministry of Finance and departments within the MOD monthly or as requested,; manages all sources of income and includes information in monthly returns, and works closely with the finance staff of the General Staff.

The Cash office controls all cash transactions within the Ministry of Defense and Armed Forces. No cash is to be authorized outside of this office. The salaries section calculates monthly salaries for all personnel confirmed to be working in a position. The salaries section is responsible for providing the list of personnel to be paid in cash.

The Financial Management department will record and account for the activities on the execution of the MoD programs, thus providing the fundamental database for determining the outlays required for each program element, sub-program and program. They also ensure recording the different programs in general ledgers and their consolidation in the General Ledger of the MoD. This group of applications also guarantees the proper distribution of funds to program elements.

Summarizing the above, the accounting function of the budget execution phase should include:

- Preparation of various financial statements and reports;
- Maintenance of general ledgers at the different levels of management (for individual programs and sub-programs);
- Consolidation of the accounting information (including reporting on programs); i.e. reporting on cash flows and financial resources; consolidated reporting of assets; consolidated reports on stocks;
- Preparation of current and consolidated reports and statements;
- Determination of expenses under the costs, program elements, sub-programs and programs;
- Accumulation of data for market prices offered by third-party suppliers for logistics functions;
- Financial control of contracts;
- Consolidated reporting on human resources, accruals, taxes.

***b. Second Level of Management***

In the General Staff and the Services Headquarters Financial Offices, the following functions should be established:

- Preparation of the draft budget on programs and sub-programs according to the established quota (percentage limits);
- Allocation of funding;
- Consolidation of accounting information from the subordinate organizations;
- Preparation of payment requests;
- Reporting on financial, human resources, fixed assets, stocks;
- Analysis of program budget execution, in addition to making adjustments and corrective actions.
- Logistics financial management functions encompass the following activities:
  - Identifying the resources needed for the achievement of program objectives through centralized purchasing;
  - Development of expense norms and rates for material and human resources for cost pricing of the programs and program elements;
  - Maintaining the minimum required “stock-on-hand” quantities at any time;

Operating clerks, responsible for fixed assets and stock reporting, should become part of the financial organs.

***c. Third Level of Management (Operational Level)***

Currently, there are no unified financial detachments to undertake the functions of the financial office of the service headquarters.

Reporting on financial, human resources, fixed assets, stocks, and other items similar to the second level activities should be established and maintained at this level. This should also include brigades and independent deployed units, such as battalions.

Major activities should deal with preparation of the draft budget for programs and sub-programs according to the established plan, double-entry accounting for cost items, programs and sub-programs and the preparation of payment requests.

### **3. From Annual to Longer-Term Planning**

I want to be around to watch the trains being loaded up at the beginning of this (PPB) process, not wait till they finish their trip and are unloaded

Donald Rumsfeld  
Secretary of Defense

...senior leaders do not focus on the front end of the PPBS process

Stuart E. Johnson

For most developing countries, it often is of almost vital interest to prepare a longer (medium) term development plan based on the strategic priorities for the next three to five years. Resolving this problem is vital because only in this case will political leaders feel responsible for their mission(s), support the conduct of “sober” public deliberations on the government’s political, economic and defense activities, build lawful institutional ties, create straightforward and workable interagency relations, and establish clear input-output-outcome links at all levels of governance.

Although the budget process is an annual cycle, increasing importance should be devoted to a medium term perspective, thus increasing predictability of agency’s spending. In this case, strengthening ties between planning and budgeting could appear in a matrix. In Georgia, the nonexistence of medium-term planning has resulted in fragmented and inefficient activities in areas, which actually should link international aid and domestic reform.

Some traps exist which make medium-term plans a “wish list” of programs and activities that cannot be realistically achieved given the political willingness and/or finances of the government. These include:

- fragmentation of the system so that policy making, planning and budgeting take place independently of each other;
- line agencies budget and spend on an ad hoc basis and discretionary allocations are unpredictable. This results in poor operational level performance of public sector agencies;
- failure to direct resources to policy priorities (if/when they exist) resulting in a lack of professionalism and/or authority and responsibility given to the line managers.

Currently, the government of Georgia acts in a close-to-the-crisis-mode, a malfunction of state institutions. PPBS is a very helpful tool for avoiding this mode and providing opportunities for long range planning. However, academic circles and knowledgeable observers are well aware that governments in almost all transitional countries function by “resourcing the current year” and getting by in the hope that “next year might be better.” If it is worse, “well, at least this year we met (or almost met) budget targets.”

A development plan essentially establishes the outcomes the country wishes to achieve over the medium term, while budgeting is focused on “inputs” (resources) rather than outputs and outcomes. Institutions in transitional countries should overcome the tendency of “normal” discussions and debates between the budget agency and a line agency, which are conducted on, e.g., how many new staff they can hire. The focus should instead be on what the agency need to produce in order to contribute to the desired social outcomes. [Ref. 42]

Only a medium-term planning framework permits advocacy for and measurement of three budgetary outcomes: aggregate fiscal discipline; allocative efficiency; and operational efficiency.

At this stage of PPB implementation, the Georgian Armed Forces need a very simplified approach to moving from annual, *ad hoc* mode budgets to a medium-term planning and budgeting, whose results are both measurable and effective. Constructing the characteristics of a real and workable system should consist of steps for moving from a line item (control) orientation of budgeting to a performance (management) and PPB (planning) orientation.

Table 9. Some Basic Differences between Budget Orientation (From: Ref. 28:p. 66)

<b>Characteristic</b>	<b>Line-Item (Control)</b>	<b>Performance (Management)</b>	<b>PPBS (Planning)</b>
Personnel Skill	Accounting	Administration	Economics
Information Focus	Objects	Activities	Purposes
Key Budget Stage (central)	Execution	Preparation	Pre-preparation
Breadth of measurement	Discrete	Discrete/Activities	Comprehensive
Role of Budget Agency	Fiduciary	Efficiency	Policy
Decisional-Flow	Upward aggregative	Upward aggregative	Downward Disaggregative
Type of Choice	Incremental	Incremental	Telic (purposeful)
Control Responsibility	Central	Operating	Operating
Management Responsibility	Dispersed	Central	Supervisory
Planning Responsibility	Dispersed	Dispersed	Central
Budget-Appropriations Classifications	Same	Same	Different
Appropriations Organizational Link	Direct	Direct	Crosswalk

According to the table above, it is clear that the major focus of budgeting should evolve from justification to analysis; budget decisions should be influenced by an explicit statement of objectives and by a formal weighing of costs and benefits of alternatives, and the budget should be oriented to an end to be purposeful. The PPB as a system is designed for these kinds of longer-term accomplishments.

The energy, attention and time of senior leaders at MoD are normally concentrated at the back end. They are often interested in the MoD budget when the deadline for submission to the Parliament is pressing. This cannot be considered efficient time allocation. It is possible to compare this stage of decision-making in the public sector agency to policy activities in private sector organizations. Late engagement in commercial activities is serious, if not fatal, for the organization. If the managers' time is spent managing crises and trying to fix a program in the late stages, their ability to influence the process is at its minimum.

Transformation of the Georgian Armed Forces should become the subject of a broad debate. Ideas and controversies will flow from many directions and from many stakeholders. The current task of decision-makers is to select highly important initiatives and “translate” them into the clear language of real outputs. For example: “Georgian Armed Forces need to have 3,000 mobile Special Operation Forces troops that can deploy within X days to conduct operations in hostile territory for at least Y days.” This would then be included in the service plan by service staffs and the General staff should monitor the process to ensure its implementation. [Ref. 43]

The Medium Term Expenditure Framework (MTEF) together with PPBS includes practical opportunities to build a logical and organized process of drafting the basic straightforward policy objectives as basic guidance, which then will require only selective changes in the following years.

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## **V. CONCLUSIONS**

### **A. SUMMARY**

Despite the fact that Georgia is a resource-rich country, Georgia's new government could not foresee the possible consequences of declaring independence in 1991. Conflicts and economic collapse occurred. The social conditions of the majority of the people worsened dramatically. Almost half the population lives below the poverty line and almost one fifth is unemployed.

After a peaceful revolution in November 2003, a newly elected legislative and executive branch faces the task of promptly resolving the accumulated complex problems. These include the uncontrolled borders, the increased smuggling along uncontrolled borders, an unprotected domestic market, the criminalization of businesses, a large shadow economy, widespread corruption, financial and budgetary crises based on insufficient tax collection, a permanent negative trade balance, a low level of investment and capital outflow, a growing foreign debt burden, decreasing production, the financial burden of refugees, the intense outflow (migration) of intellectual potential, and a high crime rate.

A stable economy would greatly increase the new administration's prospects for integrating Georgia into Western economic and security structures. This will also allow for full implementation of the PPB(E) system in the reformed Georgian Armed Forces, permit the management of programs and resources, and bringing about transparency and accountability.

Many of the weaknesses in budgeting reflect the failure to address links between the various functions, which are not unique to the Georgian State budgeting as a country in transition. The Public Expenditure Management Handbook by the World Bank summarizes all these weaknesses. Many factors create a disabling environment for public sector performance. Thus, it is possible to identify the aspects of Georgia's budget system requiring reform. One aspect is the exclusive focus on inputs, when budget performance is judged only in terms of funds spent "in accordance to the appropriations." Others are



the focus only on short-term decisions, the inability to take account of long-term costs, and the inability to budget in real terms, leading to pressure on aggregate spending or mechanical cuts during budget execution with negative consequences for the agencies. Also, the involvement of the parliament and other central agencies in decision making on the micro level, unexpected, last-minute cuts during budget execution, the unpredictability of funding for the existing government policy caused by a weak decision-making system and last-minute cuts, strong incentives to spend funds in the first half of the fiscal year, since the current year's spending is the starting point for the future year's budget plans and the fear of unexpected cuts during execution are other examples. Lastly, other issues are very little interest in analyzing the causes of policy failures, an unsophisticated approach to budget analysis from one year to the next, poor linkage between policy and resources between the center and the line agencies, weak interagency relationships, poor information on performance, the costs of policies, programs and services, and the lack of incentives to improve performance.

It is not possible to overestimate the negative effect of State budgeting and execution system shortfalls on the PPB implementation process in the Armed Forces.

National Defense is a classic case of a public good, or collective consumption good provided by the public sector. There are many, sometimes contradictory considerations among scholars about the correlation of the size of defense spending and economic wealth. Scholars try to answer challenging questions on whether and how a change in defense spending causes a modification in economic performance.

The Ministry of Defense should be seen as a public sector agency. Public sector organizations are often constrained and/or directly influenced by political considerations. A related issue is that the public sector organizations are more accountable for their decisions to outside parties, and often to the public in general, than private organizations. Decisions by managers in such organizations will often be taken in the context of political/regulatory requirements. Public sector organizations are often very formal and bureaucratic, and for this reason, may often be slow to change.

The most important reason for analysis is that the MoD, as a public sector agency, has to focus on its outputs, outcomes and their metrics. Output measures or metrics of output gradually highlighted the case for the “approved size of the Armed Forces.” In fact, there was only enough funding for the officers’ salaries and providing food to the soldiers. Training and combat readiness were not considered very important issues. Time and variance in the units’ training and tactical operations was generally not considered from the strategic standpoint, but mostly from current political complications with neighboring countries. The “just-in-time” approach to operations planning caused this deviation from the initial targets.

Existing outcome measures are very complex and consist of a number of standards for combat readiness. Measuring the final outcome or degree of achievement of the desired objectives is considered almost impossible. Only the outcome (result) of war could serve as that reason, “...the ultimate test of military effectiveness is war” and it is an “unacceptable prospect”. Outcomes, unlike outputs, depend primarily on conditions beyond agency control.

In analyzing the MOD organizational framework, it is apparent that the system’s inputs, throughput and results often do not fit with each other. For example, the historical environment often leads to false indicators for choosing the design factors. Often-changing mandates and the larger environment negatively affect the policy making culture. Performance measures are “artificially” increased at the expense of compromises in organizational integrity. Real outcomes do not correspond to the main mission and goals, and mandates are not set. The natural circulation of the organizational system is “self-destructive”. Since the agency has no clear strategic goals, outputs are not measurable, and as a result, it is not possible to create a base (foundation) for further development.

- At the current stage of economic development Georgia needs to implement clear systems of resource planning and accountability, such as PPBS in the Armed Forces. This system addresses the vital needs of a country with a weak economy such as cost effectiveness, balance between commitments and resources, transparency, priorities and coordination.

A PPBE system overview in developed countries leads to the conclusion that there is a need for understanding the specific circumstances for implementing PPBS in Georgia. One major inhibiting factor for PPBS implementation remains the practice of State budgeting under the so-called “protected items” policy. Social costs, mainly salaries and pensions, are “fenced by” the Government. In most of the State budgeting cases, only Armed Forces personnel costs are appropriated and funded. It is not reasonable to apply protected items practices automatically to the Armed Forces. The Armed Forces as an organizational system with its final product of output, defense of the state through combat readiness, relies on the following metric: zero funds allocated to Operational Readiness and Modernization results in zero improvement in combat readiness as no political, economic and social value is added!

The goal of the PPBS hierarchy is to share the responsibility of preparation, implementation and accountability of programs and budget plans. The hierarchy identifies system levels, units and program coordinators. Although the budget process is an annual cycle, increasing emphasis should be placed on a medium term perspective, which increases the predictability of spending for the agencies. In this case, strengthening ties between planning and budgeting could be matrixed. In Georgia, the nonexistence of medium-term planning has resulted in fragmented and inefficient activities in areas, which should link international aid and domestic reform.

Some traps may make medium-term plans a “wish list” of programs and activities which cannot be realistically achieved given the political willingness and/or finances of government. This includes system fragmentation that causes policy making, planning and budgeting to take place independently of each other. Line agencies budget and spend on an *ad hoc* basis, and discretionary allocations are unpredictable. This makes for poor operational level performance of public sector agencies and the failure to direct resources to policy priorities. One result is a lack of professionalism of line managers and/or their authority and responsibility.

## **B. RECOMMENDATIONS**

Currently, Georgia’s political leadership lacks an integrated view of the main goals as a hierarchy from top national leaders down to unit commanders. National goals

should be identified. Efforts should then follow to ensure their realization. Furthermore, structures built on principles of simplicity and flexibility will allow the Minister and the Joint Staff to adapt to changes easily in both peace-time, crises and wartime. Integrated structures should concentrate on operational goals and objectives. An effective organizational structure should be documented which reflects the goals of the existing forces, resource allocation practices and clear definitions of staff-members' accountability.

Managerial decisions should focus on a) developing and maintaining optimal force structure, b) conducting trends and risk analysis at the sub-system, system, and agency levels, c) conducting integrated risk analysis in case of insufficient funding and budget cuts; and d) testing and verifying combat readiness. Another important issue is budget execution and financial accountability. A very strict approach to these issues will strengthen the precise budgeting and accurate execution as an integrated system. The key would be to ensure that each issue is high-leverage and expressed in output terms.

The major focus of budgeting should evolve from justification to analysis. Budget decisions should be influenced by explicit statements of objectives and by a formal weighing of costs and the benefits of alternatives. Budgeting should be purposeful. The design of PPB as a system lends itself to these kinds of effective decision-making processes.

Transformation of the Georgian Armed Forces should become the subject of a broad debate. Ideas and controversies will flow from many directions and from many stakeholders. The current task of decision-makers is to select highly important initiatives and “translate” them into the clear language of real outputs.

The Medium Term Expenditure Framework (MTEF) together with PPBS includes practical opportunities to build a logical and organized process of drafting the basic straightforward policy objectives as basic guidance, which then will require only selective changes in the following years.

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